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PROGRAMME OF WORK OF THE INTERGOVERNMENTAL WORKING GROUP OF EXPERTS ON INTERNATIONAL STANDARDS OF ACCOUNTING AND REPORTING: DISCUSSION OF ACCOUNTING ISSUES ARISING DURING PRIVATIZATION, INCLUDING INDIVIDUAL COUNTRY CASE-STUDIES

Accounting problems arising during privatization in Mexico

Report of the Secretary-General

SUMMARY

The Government of Mexico believes that the country has developed to the point where many business enterprises should be transferred to the private sector to promote efficiency and expansion. For basic industries such as minerals extraction, utilities and transportation, control can be achieved by regulation instead of government ownership and operation. Trade sales through a bidding process and share flotations have been the primary methods used by the Government to attain its objectives to date. Specific transactions are handled by one of the commercial banks within the country as designated by the Ministry of Finance and Public Credit. Accounting standards and the auditing profession are well established in Mexico. Because of hyperinflation in recent years, however, historical financial information used for the valuation

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of companies has had to be adjusted by general price indices or expert appraisals. Banks and other financial institutions in Mexico use accounting principles in accordance with government requirements for their respective industries that are not in accordance with international standards. This problem has yet to be overcome. Also, proper accruals for environmental liabilities and potential obligations to terminated staff are matters that must be considered for every entity that is being privatized.

The following case-study is based on a written contribution by the Ministry of Finance and Public Credit of Mexico.

CONTENTS

	Paragraphs	Page
INTRODUCTION	1 - 7	4
I. OBJECTIVES OF PRIVATIZATION	8	5
II. IMPLEMENTATION OF THE PRIVATIZATION PROCESS	9 - 49	6
A. Form of privatization	9	6
B. Legal framework	10 - 15	6
C. Methods	16	7
D. Steps for privatization	17 - 29	7
E. Special cases	30 - 45	11
F. Impact of privatization	46 - 49	14
III. IMPLICATIONS OF PRIVATIZATION FOR ACCOUNTING	50 - 63	15
A. Existing accounting practices	50 - 53	15
B. Financial information	54 - 55	16
C. Submission of accounting information	56 - 59	16
D. Improving the audit function	60 - 63	17

INTRODUCTION

1. Since taking office, the present federal Government has focused its efforts on modernizing the country in all areas and improving the quality of life of the Mexican people. The National Development Plan for 1989-1994 contains the strategy formulated to guide those efforts.

2. With regard to public enterprises in particular, a modernization programme has been implemented that includes the privatization of non-strategic publicly owned entities. The aim is for a more democratic and more efficient State. Historically, different entities grew out of various situations that had resulted from the belief at the time in a need for State participation to support the country's development. Under conditions of macroeconomic stability, Mexico experienced an important transformation of its economic and productive sectors, as a result of a comprehensive policy of structural change.

3. There are a number of general considerations that have to be taken into account in order to understand the evolution of the public sector. The strengthening and consolidation of the institutions acquired by the Government at different stages of the country's development led to the creation of public enterprises or agencies to perform some of the functions that the Constitution had entrusted to the State, such as the stabilization of the national economic system and the promotion of the system's development. For example, the following were established: the Bank of Mexico, a network of development banks, the National Securities Commission and the National Banking and Insurance Commission. Some entities were set up in order to exploit strategic natural resources for the nation's benefit, produce raw materials widely used in industry and agriculture or provide the population with basic services. This was the case for enterprises such as Petróleos Mexicanos, the Federal Electricity Commission, Ferrocarriles Nacionales, Altos Hornos de México and Fertilizantes Mexicanos, among others. Other entities were set up at the initiative of the development banks, in particular the National Finance Bank, throughout the 50-year period. Projects were also promoted to eliminate bottlenecks at various stages of the country's development, produce substitutes for imports, increase export capacity, encourage the modernization of plants and generally stimulate and complement investments in the social and private sectors. From this promotional work emerged such entities as the Sidermax complex (iron and steel companies) and the capital goods industries.

4. In the same way, the public sector was also increasing the number of publicly owned enterprises by acquiring or taking over a number of companies that had originally been set up by the private sector but could not operate satisfactorily or productively. Thus, in order to protect jobs and maintain the production facilities, the State incorporated into the public sector enterprises from very different and varied economic branches, for example, State-owned commercial fisheries and sugar refineries. Other entities were created or established in order to achieve the specific goals of social welfare. They included all the institutes in the health sector and the

Compañía Nacional de Subsistencias Populares (National Staple Foods Corporation).

5. The situation described above reflects a great variety of goals that gave rise to direct participation of the State in industry, trade and services. It is useful to point out that in Mexico the reasons for that participation were very similar to those that led to the establishment of public enterprises in other countries of the world.

6. Although there was flexibility in the establishment of public enterprises there was little flexibility in removing public enterprises from the public sector once the purposes for which they had been created were achieved. This imbalance, added to the accelerated growth of the public sector in certain periods, resulted in adverse situations that limited the development of the enterprises themselves, impairing their efficiency and effectiveness in terms of both their own management and their contribution to national objectives. The result was participation in economic activities that, more extensive than selective, made institutional coordination more difficult and consequently reduced the impact of the activities of those enterprises on the national economy. At the end of 1982, the State was participating in 45 branches of economic activity through 1,155 publicly owned entities, covering such diverse manufacturing areas as woolen fabrics, soft drinks, chinaware and bicycles.

7. On the other hand, this situation made possible the attempt to pursue many different objectives with a single instrument - public enterprise. However, taken as a whole, regulation of the market, granting of subsidies, creation of jobs, promotion of technology and exports, coverage of the market and support for other public enterprises were objectives that were often difficult to achieve satisfactorily in the administration of publicly owned enterprises. Sometimes the result was the financial, administrative and operational weakening of the enterprises themselves.

I. OBJECTIVES OF PRIVATIZATION

8. The difficult financial situation of the federal government resulting from the general economic conditions of recent years highlighted the urgent need to secure greater rationality and efficiency in publicly owned enterprises. Towards the end of 1982, the government department responsible for the public sector called for structural changes to (a) streamline the State's role in economic activities, (b) strengthen control by eliminating elements of secondary importance and concentrate on what was fundamental and necessary, (c) consolidate the position of those enterprises in which the State was to retain a role and (d) extend the framework of a mixed market economy. The economic crisis confronting the country in the early 1980s, the weaker financial position of the State and the shortage of resources for many publicly owned entities created the need to devise and implement a policy to secure concentration of the federal government's resources in the strategic areas defined in the Constitution and in the priority areas demanded by economic policy.

II. IMPLEMENTATION OF THE PRIVATIZATION PROCESS

A. Form of privatization

9. The scaling-down of the public sector entails not only the sale of enterprises but also the consideration of other options: merger, reduction of operations, transfer and winding-up. The selection of one of these options depended on the specific situation of the enterprise at the time that the decision to privatize was made. Entities that had already achieved their goals or were not economically viable were wound up or had their operations curtailed. Enterprises were merged in order to improve the use of their resources for various purposes, such as marketing and activities complementary to the production process. As set forth in the National Development Plan for 1989-1994, State Governments were given control of priority enterprises of regional or local importance for their development programmes, and enterprises were sold if they were not strategic or priority enterprises and there was some benefit in their acquisition by the social or private sectors.

B. Legal framework

10. The legislative and juridical basis for the privatization of publicly owned entities is the Political Constitution of the United Mexican States. In accordance with article 134 of the Constitution, the divestment of publicly owned entities has usually been carried out by public competitive bidding in order to ensure the best terms of sale for the State in regard to price, timing and other relevant matters. In addition, capital has been raised through public offerings of securities on the domestic and international exchanges. The section of the present study entitled "Special cases" includes a description of the recent highly successful flotation of shares of Teléfonos de México (TELMEX).

11. Articles 25 and 28 of the Constitution set forth the strategic areas for government control and establish the framework within which the State will collaborate with the social and private sectors to promote and to organize development activities.

12. The Federal Law on Public Entities, dated 14 May 1986, sets out the fundamental provisions governing the relations between the central and public sectors within a framework of greater managerial freedom. In the exercise of his regulatory powers, the President of the Republic issued the Regulations for the Federal Law on Public Enterprises. The Regulations published on 26 January 1990 in the Official Gazette, were established to govern the creation, organization, operation, control and closure of public entities.

13. The privatization of public entities has to be kept in line with the forecasts in the federal budget. For public entities created by the Congress, the Congress's prior authorization is also required. The transfer process, in addition to being based on the laws and regulations mentioned above, is guided by the procedures that the Inter-Ministerial Commission on Expenditure drew up

for this purpose. This Commission is a collegial body comprising the Ministry of Finance and Public Credit, the Ministry of Planning and Budget, the Office of the Controller-General of the Federation, the Ministry of Trade and Industrial Development, the Ministry of Labour and Social Security and the Bank of Mexico. The Ministry of Finance and Public Credit is responsible for coordinating, supervising and implementing the sale of publicly owned companies. 1/

14. With a view towards strengthening the action of the federal Government in the sale of public companies, the President of the Republic has, by decree, created the Privatization Unit for Publicly Owned Entities within the Ministry of Finance and Public Credit. This Unit consists of six persons at the management level, together with supporting staff.

15. To support these actions, a total reform of the financial sector of the economy was undertaken as well. The availability of capital both domestic and foreign was increased by a programme to strengthen and modernize the financial sector that was adopted in 1989. These measures applied mainly to the banking sector and to the stock market, and among the many measures taken were an increase in the minimum capitalization required for financial intermediaries, creation of private pension funds, increase in the maturity dates of government securities, a reserve requirement for banks of 30 per cent of deposits, permission for banks to place their certificates of deposit on the secondary market, privatization of State banks, liberalization of interest rates, elimination of automatic credit lines to certain sectors and creation of deposit insurance.

C. Methods

16. The process of privatization by means of the sale of companies is extemely broad and complex but many of the formalities are the same for all companies, irrespective of their size. The procedures followed in the transfer of state-owned entities are described below.

D. Steps for privatization

1. Proposal of the coordinating agency

17. The process is formally initiated when the ministry that bears responsibility for the industry sector, considering that the company in question is neither a priority nor of strategic importance, presents its proposal for privatization to the Inter-Ministerial Commission on Expenditure. For example, if a hotel were involved, the proposal would be a matter for the Ministry of Tourism; but a sugar mill-related proposal would be a matter for the Ministry of Agriculture and Water Resources.

2. Opinion of the Inter-Ministerial Commission on Expenditure

18. The Inter-Ministerial Commission on Expenditure analyses the proposal and, depending on the company's general situation, economic sector and operational background, determines the most appropriate form of privatization. As mentioned above, that may be winding-up, reduction of operations, merger, transfer or sale.

3. Privatization agreement

19. If it is decided that the company is to be sold, the Ministry of Planning and Budget, pursuant to its mandate, 2/ sends an official communication to the Ministry of Finance and Public Credit to start the sales process.

4. Designation of the agent bank

20. The Ministry of Finance and Public Credit, in all cases, designates one of the country's 18 commercial banks to act as sales agent for the federal Government. The decision as to which particular bank will conduct the sale depends on its experience and workload. The Privatization Unit for Publicly Owned Entities of the Ministry of Finance and Public Credit analyses the situation of the individual company and, in coordination with the designated agent bank, develops the sales plan.

5. Features of the sale

21. Once the sales plan has been prepared and approved and the characteristics and specific situation of the company established, the agent bank proposes to the Ministry of Finance and Public Credit general guidelines for the sale. Among the most important matters are: convening of meetings, conditions of sale, timetable of activities, profile of the enterprise, prospectus and amount of the deposit to be received. All of these matters require the final approval of the Privatization Unit for Publicly Owned Entities.

6. Sales profile and prospectus

22. The agent bank prepares two documents. The first is an informational profile, which is a brief document describing the general characteristics of the company. At this time an advertisement is published in the major local newspapers informing interested parties that the company is for sale and that they can obtain preliminary information. The second document is the descriptive prospectus containing the most relevant information on the company, including such items as financial statements, labour situation and general business operations. In order to obtain the prospectus it is necessary, in the majority of cases, to deposit an amount whose size varies

according to the size of the company. A written commitment to maintain confidentiality (specifying that any information received will not be divulged during a specific period of time) is also required. In addition, interested parties are invited to pay a technical visit to the company.

7. Technical-financial appraisal

23. On the basis of the information provided by the company, the agent bank, employing a variety of methods, prepares a study, referred to as the technical-financial appraisal or valuation. Financial measurements frequently presented are equity value (that is, the value of net assets or assets less liabilities), current value of future cash flows, liquidation value and market value. The results of this analysis will provide a minimum indicative value, which will be employed as a yardstick in considering offers, of the enterprise's worth. The company may be sold for a different amount, depending on market conditions. Generally speaking, such appraisals are made by national experts but in certain cases, if the situation so requires, the opinion of international experts may be requested. Mexican companies that have used such international services include: Compañía Mexicana de Aviación, S.A. de C.V., Teléfonos de México, S.A. de C.V., Compañía Minera Cananea, S.A., Siderúrgica Lázaro Cárdenas Las Truchas, S.A., and Altos Hornos de México, S.A.

24. Of all the transactions carried out by the current Administration, 88 per cent (121 enterprises) involved transfers at a price equal to or greater than the recommended minimum amount, while only 12 per cent (17 enterprises) were sold for lower amounts. Most of the enterprises that were sold for less than their appraised value were sugar refineries. In such cases, the operating conditions encountered, labour and financial problems, and the unpredictability of sugar cane and sugar prices had led to judgements that the value of those enterprises was lower than originally projected.

8. Assessment of bids

25. In accordance with the principles for sales, the agent bank receives the bids in a sealed envelope. This takes place with the greatest possible transparency in the presence of a notary public and of representatives from the Ministry of Finance and Public Credit and the Office of the Controller-General of the Federation. Afterwards, the Institute of Credit standardizes the bids so as to facilitate comparison. When a bid is analysed, the plans of the purchaser with regard to the enterprise are taken into account, as well as the price of the transaction and conditions of payment. It is important for the federal Government to know the future investment and employment plans of the purchaser. Nevertheless, the most important consideration in the assessment is the price.

26. The sales agent bases his or her recommendation to the Ministry of Finance and Public Credit on the proposal guaranteeing the most favourable

conditions of sale for the State. In the event that all bids are below the recommended minimum amount or only one bid is submitted, the results obtained are set out before the Inter-Ministerial Commission on Expenditure and the Commission makes a decision, either designating a purchaser or, if there is no suitable bidder, reopening the bidding. In general, enterprises are offered for bid three times, and if a favourable result if not obtained, on the specific authorization of the Inter-Ministerial Commission on Expenditure direct negotiations are held with the interested party or parties and representatives of the Office of the Controller-General of the Federation.

9. Authorization and decision on sale

27. When the judgement of the Inter-Ministerial Commission on Expenditure is favourable, the Ministry of Finance and Public Credit issues an official note of authorization and decision of sale in favour of the most favourable bid for the State.

10. Formalization of the sale

28. The unit owning the federal Government's shares and the purchaser sign the contract of sale, thus formalizing the transaction. The purchaser then carries out a buyer's audit which is submitted for consideration to the Ministry of Finance and Public Credit, and if any claims are made and accepted, the relevant amounts are disbursed. The proceeds of the sale are deposited in the Treasury of the Federation in accordance with the contract of sale. The Ministry of Finance and Public Credit sends to the Ministry of Planning and Budget and to the Controller-General at the Federation an official note to begin the formal deletion of the enterprise from the group of public bodies (attaching copies of the contract of sale and the payment to the Treasury of the Federation).

11. Compiling the "white book"

29. When the sale has been concluded the agent bank is responsible for preparing a document called the white book, which is a collection of all of the official documents related to each stage of the transfer process. The Coordinator of the Privatization Unit for Publicly Owned Entities sends the white book to the Ministry of Planning and Budget, the Ministry having responsibility for the industry sector, and the Office of the Controller-General of the Federation so that, in accordance with the powers conferred on that Office, it can monitor and oversee the privatization processes. In addition, a copy is sent to the accounting office of the chamber of deputies so that an expert body can make appropriate valuations of the enterprises sold.

E. Special cases

30. As explained earlier, these are the general procedures for the transfer of public companies. There are, however, other arrangements for specific enterprises that require special strategies for such sales. The following cases are examples.

Compañía Mexicana de Aviación

31. In the case of this airline an option was sought that would spare the Government the expense of having to meet from its own resources enormous investment requirements and would at the same time develop the enterprise and obtain for the Government a fair price for its shares. It was decided that the mechanism of capital infusion, by which the proceedings of the sale would not be deposited in the Treasury of the Federation but employed to capitalize the enterprise, would be used. With this strategy the State promoted the growth and modernization of Mexicana de Aviación, and the resources that it did not have to transfer to that public company were channelled into other high-priority expenditure items. The enterprise was capitalized at $140 million.

Fisheries

32. A scheme was devised to fit the particular characteristics of fisheries and to provide for participation in the enterprises of private financial agents through capital investment companies (SINCAS). This proposal and the criteria governing the scheme were authorized by the Inter-Ministerial Commission on Expenditure and, as in the other transfer processes, depended on the support of the agent bank working together with a brokerage house. Under this scheme the transfer processes have been concluded for four fisheries in two packages, the first package comprising Pesquera del Pacífico, S.A. de C.V., and Productos Pesqueros de Topolobampo, S.A. de C.V., and the second, Productos Pesqueros de Siunaloa, S.A. de C.V., and Productos Pesqueros de Matanacitas, S.A. de C.V.

Sugar refineries

33. Most of the sugar refineries privatized during the present Administration had been operating at a loss for recent sugar harvests and the rate of return had been lower than the national average. In order to encourage the sale, balanced packages were created and a payment scheme designed that was based on bonds pegged to the price of sugar. Just like all the other transfer processes, the sales were formalized with the conclusion of a contract of sale. In this case, a cash payment of 20 per cent was made when the contract was signed and the remaining 80 per cent was paid through issuance of the above-mentioned bonds. Sixteen sugar refineries have now been privatized under this arrangement.

Teléfonos de México (TELMEX) 3/

34. In order to privatize Teléfonos de México, the government authority responsible for the industry sector first proposed pursuing the following objectives which were identified by the President of the Republic:

(a) A substantial improvement in service;

(b) Steady expansion of the existing system;

(c) Strengthening of research and technological development;

(d) The guarantee of the rights of workers and of their share in the equity of the enterprise;

(e) The guarantee that Mexicans would hold a controlling interest in the entity.

35. In order to fulfil the first three objectives, updated programmes were needed for the expansion, improvement and modernization of the telephone system and for the undertaking of industrial and technological research that would increase the competitiveness of the enterprise and of the country in the field of telecommunications. TELMEX would have to increase its number of lines by an estimated annual average of 12 per cent between 1990 and 1994. By 1995, every village with more than 500 inhabitants should have at least one long-distance public telephone. By 1995, public telephone kiosks should be installed with a density of 5 kiosks for every 1,000 inhabitants. By the year 2000, the waiting time for the installation of new service lines in cities with a population of more than 5,000 should be reduced to one month.

36. At the same time, the concession from the Government provides for detailed quality-of-service goals, the designation of a councillor by the Ministry of Communications and Transport until August 1993 and the introduction of a system of rate regulation through price ceilings. The concession, which went into operation in 1991, provides that TELMEX service rates will be subject to a price ceiling in real terms on its basic telephone service package.

37. A substantial amount of new capital was necessary if the objectives of the government authority were to be accomplished. The securities market represented an efficient alternative for financing productive investment. In this sense, the market has gained new importance in Mexico's current economic development and was also felt to be an ideal vehicle for attracting foreign resources through portfolio investment, as well as a key instrument in the privatization process of government enterprises. Thus, a decision was reached to raise this capital through a very large equity shares flotation.

38. The process was planned in two stages. The first stage involved financial arrangements for the divestiture of the company, based on a restructuring of its capital stock through declaration of a dividend in new

shares series L with limited voting rights, and several legal procedures to maximize the liquidity of those shares and their acceptance in world markets. Through this mechanism, the control package, represented by series A shares equivalent to 20.4 per cent of the total capital, was put together. In a public auction in December 1990, this package was assigned to Grupo Industrial Carso, a Mexican holding company associated with Southwestern Bell Telephone of the United States of America and France Telecom. The second stage consisted in the public offering of series L shares, which the Mexican Government had received as a dividend for its participation in the company.

39. Owing to its nature, this transaction required the standardization of legal and accounting principles in the markets that were participating in the process, in this case, the New York Stock Exchange (United States) and the Bolsa Mexicana de Valores (Mexico). The objective of the Mexican authorities in the international offering was to provide equal opportunities to all participants. Owing to differences in the public offering processes of the United States and Mexico, the following basic principles were established:

(a) Full and timely disclosure of information regarding the issue;

(b) Simultaneous pricing of the offering;

(c) Coordinated initiation of transactions in the secondary market.

40. Because the majority of shares were placed in the United States, close collaboration between the Mexican and United States Securities Commissions was required to establish the mechanisms necessary to successfully incorporate the TELMEX L shares in the major world markets.

41. During the offering period, the distribution in Mexico of a preliminary prospectus in Spanish (the so-called red herring) was authorized as a new practice in the Mexican market that provided for the disclosure to all potential investors of comparable information at the same time.

42. The underwriters for the offering were commercial banks (government-owned at the time) in Mexico, and Mexico's industrial development bank, Nacional Financiera. It was recognized that the participation of these institutions in the securities market should be carried out independently from their main shareholder, the federal Government, which in this particular case was the entity offering the shares.

43. During the selling period, it was necessary to reconcile and coordinate a great number of regulations and practices of several countries for the global offering that was being made.

44. The placement was completed just a few hours after having been initiated, causing the underwriting syndicate to dissolve the very first day. The Mexican Government received two payments: $375 million, representing 138 million shares placed on the Mexican stock exchange and the sale of 150 million shares for the TELMEX union workers' fund, and $1.79 billion

resulting from the placement of 1.515 billion L shares in the United States, Europe, Canada, Japan and the rest of the world. The total offering amounted to $2.17 billion.

National credit institutions

45. A presidential agreement established the principles and bases of the process of privatizing national credit institutions and commercial banking institutions. The Bank Privatization Committee, presided over by the Ministry of Finance and Public Credit, was established for that purpose. 4/ In view of the technical details and complexity of the bank privatization process, the Committee designed, subject to the provisions of the presidential agreement, an integrated sales scheme in three stages: valuation of institutions, registration and authorization of possible purchasers and transfer of shares held by the federal Government. To implement the first stage, the Committee decided upon two valuations: one to be undertaken by the banks themselves, supported by various consultants or investment banks and the other to be done by consultants commissioned by the Committee. To that end, it engaged the services of prominent national and international consultants possessing broad experience in the field of banking systems who were also collaborating in the preparation of sales prospectuses.

F. Impact of privatization

46. The human and financial resources that were released as a result of streamlining the State's role in the economy have been redeployed to priority areas. Privatization has contributed to industrial modernization efforts and to the effective and appropriate exercise of State supervision within the new realities of national and international markets and strengthened the State's capacity to meet the social service demands of the population. Mexico's experience with the transfer of public companies has been satisfactory in terms of both the number of entities sold and the transparency, efficiency and strict legal integrity of the transactions concluded.

47. As of May 1991, 826 enterprises had been privatized (including 141 sold to the private sector), 138 were in the process of privatization and 264 remained in State ownership. The sales to the private sector (primarily to Mexican citizens) raised $Mex 16.6 trillion (US$ 5.5 billion) for the Treasury. Of all the transactions carried out by the current Government, 86 per cent (121 enterprises) involved transfers at a price equal to or greater than the recommended minimum amount, while only 12 per cent (17 enterprises) involved sales for lower amounts. Most of the enterprises that were sold for less than their appraised value were sugar refineries. In those cases, the operating conditions encountered, labour and financial problems, and the unpredictability of sugar cane and sugar prices led to judgements that the value of the refineries was lower than originally projected.

48. Unquestionably, the simplest stage of the programme has been completed, since the smallest companies have been privatized. However, the experience

acquired in that process has created the necessary conditions for dealing with more complex cases, including companies that have had to undergo extensive restructuring not only of their financial systems, but also of their operations. The privatization of public entities has been included as one component of the economic modernization that is intended to help meet primary national objectives.

49. As a result of privatization, the Government now focuses more attention on basic issues, promoting the social infrastructure and responding more efficiently to the demands of the population. The Government also consolidates and fulfils its constitutional duties and gives highest priority to national development to guarantee a better quality of life for Mexican citizens.

III. IMPLICATIONS OF PRIVATIZATION FOR ACCOUNTING

A. Existing accounting practices

50. In general, all public companies follow accounting practices that are consistent with accrual accounting. Businesses outside the financial sector, for example, Teléfonos de México (TELMEX) and Altos Hornos, use a business accounting system based on the accounting principles promulgated by the Mexican Institute of Public Accountants (IMCP). IMCP principles are consistent with those promulgated by the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) and by the International Accounting Standards Committee. In the financial sectors, banks, investment firms and insurance companies employ accounting systems based on government regulations that differ from IMCP principles.

51. The privatization of banking institutions is now in progress; consequently, ways of adapting the accounting system to IMCP principles and hence to international standards are being studied. No problems arise when companies outside the financial sector are privatized provided that their practices comply with international standards.

52. The accounting systems of public corporations are very complex since they must provide the following information:

(a) Budgetary accounting required by the federal Government;

(b) Management accounting required by management;

(c) Financial accounting for the audits that must be conducted by the Controller-General or an independent public accountant;

(d) Tax accounting for the payment of taxes.

53. In the light of the foregoing, the administrative burden connected with the accounting system is considerably lightened when a company moves from the public sector to the private sector.

B. Financial information

54. Since 1979 Mexico has had an effective accounting standard for dealing with inflation. Given the rate of inflation in Mexico in recent years, financial information should be adjusted through either general price indices or expert valuation reports. The assets of non-financial-sector businesses previously owned by the Government are appraised using the general price index. However, banks utilize appraisals by in-house experts. (In the private sector they must always be independent experts.)

55. As a rule, appraisals are made by public accountants or expert appraisers registered with the National Securities Appraisal Commission, a unit of the Ministry of Finance and Public Credit. In order to practise public accounting, an individual must hold a licence that is recognized by the Ministry of Public Education, belong to an association of professional accountants and satisfy the requirements of a continuing education programme. To be accredited as an expert by the National Securities Appraisal Commission, an individual must hold the diploma of ingeniero and have specialized studies in some specific area.

C. Submission of accounting information

1. With regard to public sector companies undergoing privatization

56. Banks must bring their financial statements into line with international standards since their present accounting practices are not consistent with such standards. Other State-owned companies need to make only a few changes to conform to international standards. In all cases, companies need to revalue their assets to replacement cost. As for trade marks and other intellectual property rights, the country has had little experience in the valuation of such intangible assets. Businesses have almost no assets under this heading except amounts specified by national and international standards.

57. Regarding the estimation of liabilities, two problems arise, one relating to environmental pollution and the other to staff terminations. Pollution problems have led to the issuance of new standards and rules regulating economic activities; as a result, companies have been forced to make investments in equipment, relocations or changes in processes that in the normal course of operations they would not have considered.

58. In Mexico an employee who is dismissed is entitled to a seniority bonus, which is an amount equal to as much as 20 days per year of service, plus three months pay. There are no mandatory pension schemes. A number of banks have benefit plans that include these features, but in all other companies there is no provision for recording liability (though some have a bonus feature) because the amount cannot be accurately quantified and, if the employee has been dismissed justifiably, no payment is required. Nevertheless, when a company with staff having above-average seniority is sold, provisions are made for liability to be taken into account in the sales transaction.

59. The standards established by the National Banking Commission are currently being phased out in favour of IMCP accounting standards, which will bring the Commission's standards into line with international standards. In that connection, only IMCP standards are recognized in circulars of the Commission relating to financial information. It should be noted that, as in other countries, the accounting standards must be met in order to enable the National Banking Commission to perform its functions of control and supervision. Banks must overhaul their accounting systems in order to comply with generally accepted accounting standards and National Banking Commission rules. In the case of State-owned companies other than banks, there is a need to simplify the chart of accounts in order to eliminate budgetary control by Government.

D. Improving the audit function

60. The Office of the Controller-General of the Federation and the Ministry of Finance and Public Credit require a financial audit of companies in the public sector regardless of whether those entities have enough internal staff resources with the requisite skills for that purpose. In addition to financial auditing, standards for operational auditing are being tested. Financial auditing is performed according to rules established by IMCP. Those rules are fully consistent with the standards of the International Federation of Accountants (IFAC).

61. The Mexican Institute of Public Accountants sets standards for:

(a) Auditing;

(b) A code of professional ethics;

(c) Continuing education.

62. An example of the accounting activities related to a large privatization undertaking occurs in the case of a large public utility, Teléfonos de México, S.A., which was sold via an equity share flotation. The company applied IMCP accounting standards both before and after privatization and was registered on the New York Stock Exchange, where the United States Securities and Exchange Commission (SEC) accepted financial statements based on generally accepted accounting principles as understood in Mexico and only required that reconciliation be effected in the notes to the financial statements in order to make such statements conform to generally accepted American accounting principles. Financial statements prepared in accordance with Mexican principles have also been accepted for the registration of bonds that were issued in Europe.

63. In conclusion, Mexico has technical resources in accounting that are regarded as satisfactory, that is, (a) resources are committed to all levels of education, (b) national and international accounting standards are followed, (c) national and international auditing standards are adhered to and

(d) a professional organization steadfastly promotes professionalism and continuing education (in the Republic of Mexico there are 50 colleges affiliated with IMCP). As was noted above, the basic problem in connection with accounting standards lies with the financial sector - banks, brokerage firms and insurance companies, which continue to follow their own industry accounting rules. Those companies are not able to provide financial information in accordance with international standards.

Notes

1/ Procedures for the Transfer to the Social or Private Sectors for Valuable Consideration of Securities Representing the Equity of the Federal Government or any Public Entity in Companies in which the State Holds a Controlling Interest (September 1990).

2/ See article 32 of the Charter of the Federal Civil Service, and articles 32 and 68 of the Federal Law on Public Entities.

3/ The information on TELMEX is based on a presentation by the Chairman of the National Securities Commission of Mexico at the Sixteenth Annual Conference of the International Organization of Securities Commissions (Washington, D.C., 1991).

4/ See the Official Gazette, 25 September 1990.

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PROGRAMME OF WORK OF THE INTERGOVERNMENTAL WORKING GROUP OF EXPERTS ON INTERNATIONAL STANDARDS OF ACCOUNTING AND REPORTING: ACCOUNTING ISSUES ARISING DURING PRIVATIZATION

Accounting problems arising during privatization in Poland

Report of the Secretary-General

SUMMARY

Following the political changes in 1990, the new Government of Poland is seeking to privatize much of its economy to improve efficiency and effectiveness. Gross domestic product declined 12 per cent in 1990 and another 8 per cent in 1991, with the loss of many of its traditional foreign markets. Small- and medium-sized enterprises are rapidly being sold, rented or leased to entrepreneurs. Large enterprises are being restructured and sold in public share offerings to domestic and foreign investors or are being distributed to the citizens through an innovative coupon scheme. As is the case with other countries in transition to a market economy, there is a shortage of domestic capital for investment in business enterprises. Restrictions on foreign investment and political instability have inhibited large inflows of new capital into Poland, but this should change with

* E/C.10/AC.3/1991/1.

legislation recently passed by Parliament. The new Securities Exchange has limited trading activity, but it is developing. Providing adequate financial information for investors and managers in a market economy is a problem for all countries whose accounting systems served the needs of central planners. Poland is developing an appropriate accounting system and is training educators and practicing accountants. The Association of Professional Accountants is in its formative stage. Valuation of enterprise assets and liabilities is difficult in this environment because historical information is of little use in predicting future results of operations. Substantial inflation has further complicated the valuation process.

CONTENTS

	Paragraphs	Page
INTRODUCTION		4
I. FACTORS INFLUENCING THE SELECTION OF PRIVATIZATION METHODS	1 - 20	4
A. Improving economic effectiveness	2 - 3	4
B. Developing the capital market	4 - 5	5
C. Socio-political goals	6	5
D. Availability of local capital	7 - 9	5
E. Foreign investment	10 - 13	6
F. Existing capital markets	14	7
G. The Securities Exchange	15	9
H. The banking system	16 - 20	9
II. PRIVATIZATION STRATEGIES USED IN POLAND	21 - 28	10
A. Large enterprises	22 - 25	10
B. Small- and medium-sized enterprises	26 - 28	11
III. IMPLEMENTING THE PRIVATIZATION PROCESS	29 - 48	12
A. The Privatization Act	29 - 32	12
B. Two models of privatization	33 - 44	13
C. Difficulties in implementing privatization	45 - 48	18
IV. IMPLICATIONS OF PRIVATIZATION FOR ACCOUNTING	49 - 69	19
A. Use of commercial accounting systems by State enterprises	50 - 53	19
B. Accounting and valuation processes	54 - 55	20
C. Presentation of accounting information in privatization	56 - 69	20
References		27

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INTRODUCTION

I. FACTORS INFLUENCING THE SELECTION OF PRIVATIZATION METHODS

1. The privatization process in Poland has been driven by two main sets of goals: economic and socio-political (Borowiecki, 1991, pp. 100-103), with economic goals commanding the most immediate attention. Long-term economic goals are aimed at demonopolizing and restructuring the economy, and at creating mechanisms for encouraging inflows of capital, so as to bring about competition and promote efficiency and effectiveness throughout the economy. In the short run, it is hoped that the privatization programme will have anti-inflationary - and thereby stabilizing - effects.

A. Improving economic effectiveness

2. The main, and most compelling, economic goal, is to increase the effectiveness of enterprises and the effectiveness of the economy as a whole, so as to expand national income. The statistics for the first four months of 1991, released by the Central Statistics Office at the end of May (Rzeczpospolita, 25-26 May 1991), reveal a budget deficit of about 9.6 billion zlotys, or over US$ 800,000, mainly due to the poor financial results of State enterprises, which were supposed to provide over 90 per cent of State's current revenues. Only 60 per cent of the more than 19,000 enterprises were in a break-even or profitable condition, but it is not clear whether, even though not in a loss position, they were able to pay dividends 1/ and taxes. For many enterprises, the most immediate cause of their financial difficulties has been the collapse of the Soviet markets. Others have been affected by the loss of military business. Because decision-making power is shared between management, the workers' councils, and the Solidarity Union, financial difficulties have been exacerbated by a general reluctance to lay off workers, which has led to the stockpiling of unsalable goods, maintenance of excessive payroll levels, and, in certain cases, mounting interest, as loans were taken out to cover operating expenses.

3. Privatizing the enterprises would bring them under the Commercial Code, giving top management a much freer hand since a workers' council would be replaced with a supervisory board. It is also generally assumed that managers would give first priority to improving their company's economic and financial results, rather than to steadily increasing payrolls which is the highest priority of the workers' councils (Kotowicz, 1991). Workers have also generally supported privatization, primarily because of the potential for wage increases. This is because commercial companies are not subject to the prohibitively high taxes on increases over a defined norm in average pay.

B. Developing the capital market

4. A secondary economic goal is developing the capital market so as to obtain at least three main benefits: structural change in the economy, brought about by capital investment in sectors heavily favoured by domestic demand; inflows of foreign capital pursuing perceived profitable opportunities; and greater access to international capital markets helping to integrate the domestic and international communities. This means, of course, that conditions for developing the capital market have to be compatible with encouraging foreign investment.

5. While domestic financial markets are being strengthened, market forces and competition are being stimulated, and enterprise performance is being improved, some of the burdens on the State treasury will be relieved through proceeds from the sale or lease of State property. So, until private and privatized enterprises can supply the necessary inflows of tax revenues, the State will have to depend on realizing its assets through sales or leases in order to help finance its operations.

C. Socio-political goals

6. The privatization process has various, and interconnected, social and political objectives. Building a democratic way of life requires the stability which comes with a community of shared interests. This could be furthered by limiting State intervention in economic processes and increasing worker motivation to achieve personal goals by taking an active part in economic affairs. The various privatization techniques described in this study are heavily geared to encouraging popular participation by way of, for example, management/employee buyouts, leasing, receiving equity in investment groups through privatization coupons, and buying shares in largely privatized enterprises.

D. Availability of local capital

7. Poland's plans to transfer most of its equity in some 8,000 State enterprises to private ownership within the next five years could run into financing problems because of the low level of available domestic capital and the present restrictions on foreign investments.

8. The value of State property to be privatized is estimated at about $40 billion. The average Polish citizen has very little experience with, or understanding of, the investment process and earns about $150 per month. Assuming that the citizenry would be interested in investing 10 per cent of its approximately $10 billion in domestic savings - that is to say $1 billion, there would be a shortfall of $39 billion. Under the present law, only $4 billion of this amount could come from abroad, because foreign acquisitions of shares are restricted to 10 per cent. So, there is a significant gap of $35 billion in the financing plans (Sopocek, 1990).

9. Measures aimed at filling the void for capital started getting under way in the first half of 1991 and involve at least three mechanisms: easing the financial strain on small investors by providing for leasing, rather than purchasing, property and permitting purchases on an instalment basis rather than a cash-only approach; developing a scheme for creating investment funds, operated by Western experts, in which adult Polish citizens would receive participation certificates through the issuance of free privatization coupons, as described below; and revising the provisions for foreign investment.

E. Foreign investment

10. There are three basic ways for foreigners to carry out business activities in Poland (KPMG, 1991, p. 9): through investment in a company incorporated with limited liability, or in a joint stock company, created in accordance with Polish laws, 2/ or by establishing a representative office of a foreign company. Under the present law, the first two methods require approval by the Foreign Investment Agency (FIA), unless they have to do with forming a bank with foreign investors or establishing a bank representative office, which would require approval by the President of the National Bank of Poland (NBP) in agreement with the Minister of Finance. Establishing a representative office not connected with banking requires approval by the Ministry of Foreign Economic Relations.

11. By mid 1991, nearly 4,000 foreign investment licences had been issued, mostly for small businesses, including about 2,500 for joint ventures. As of the end of 1990, foreign investment in Poland totalled just under $200 million (Bobinski, 1991a) with about 80 per cent related to joint ventures in operation. This relatively small sum reflects investor concerns over the high risk associated with political and economic instability and the controls over currency exchange and profit repatriation.

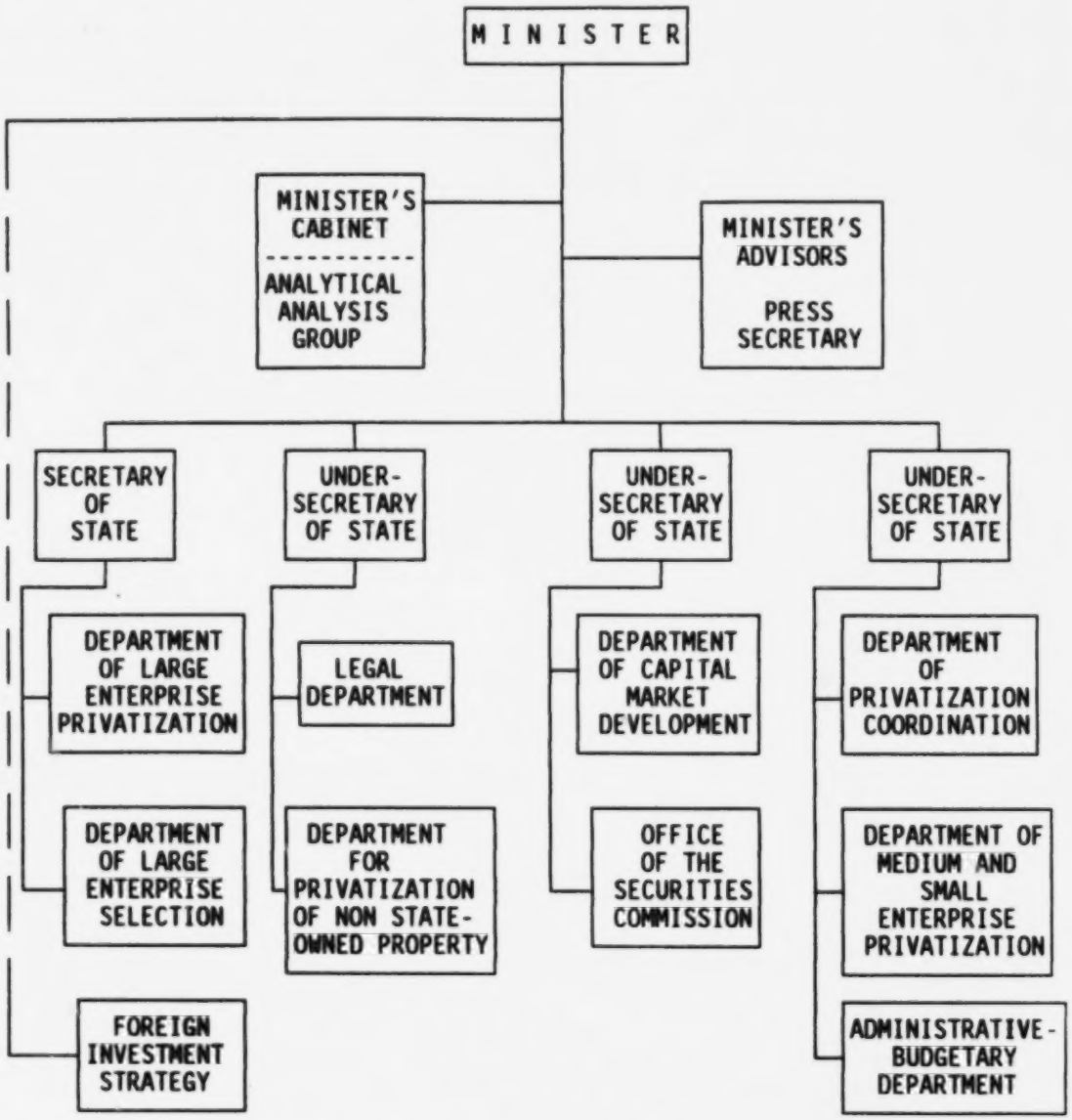
12. A fourth way for foreigners to invest in Poland would be to acquire shares in privatized companies. However, the Privatization Act (13 July 1990) puts a low ceiling on foreign participation by requiring the approval of the President of the Foreign Investment Agency for foreigners to acquire shares whose par value exceeds 10 per cent of the share capital.

13. A new draft investment law, approved by parliament in mid June 1991 (Bobinski, 1991a), aims to attract more foreign investment by changing certain administrative arrangements and improving various conditions. The Foreign Investment Agency would be replaced by an investment promotion agency. The 10 per cent limit on acquisition of privatization shares by foreigners would be lifted, as would many of the current requirements for licences for investment purposes, and future licence requirements would come under the jurisdiction of the Ministry for Ownership Transformations.

F. Existing capital markets

14. Review of Poland's capital markets, which consist of the newly created Securities Exchange and the banking system, brings together the two main agencies in privatization's institutional arrangements: the Ministry of Finance, and the Ministry for Ownership Transformations. The former is responsible for privatization of the banking and insurance sectors and works closely with the independent president of the Polish National Bank (NBP) who sets the guidelines for banking policies. The Ministry for Ownership Transformations is responsible for privatizing the rest of the economy and one of its organizational units, as illustrated in figure 1, the Securities Commission, is the oversight body for the Securities Exchange.

Figure 1. Organization structure of the Ministry of Ownership Transformations



Source: Centrum Prywatyzacji, Vademecum Prywatyzacji, Warsaw, 1991, p. 211.

G. The Securities Exchange 3/

15. The Securities Exchange, which was inaugurated on 16 April 1991, is legally organized as a company solely owned by the State Treasury. Initially, only the five large enterprises privatized through public share offerings in November and December 1990 were listed. Because of low volume trading, the exchange held sessions only once a week, on Tuesdays, lasting three hours. Following the sixth privatization, in May 1991, of the Swarzędz furniture factory, a second weekly session will likely be added. Operations are modelled on those of the French regional bourse in Lyon which is order-driven, or dependent on orders, rather than price-driven, with continually changing prices, as in New York, for example. Until they are licensed, brokers are prohibited from providing investment advice to the public. Consequently, the press assumed a very influential role in stimulating investment interest, which has grown from a turnover of 40 million zlotys (then worth just over $4,000) at the first session of the exchange to just over one and a half billion (about $158,000), or almost 40 times more, some four weeks later.

H. The banking system

16. Poland started the reform of its banking system at the beginning of 1989 so as to increase both the number of banks and the range of services they could offer. Three years later, the number of different banks had grown to 74, many of them with branches across the country (KPMG, 1991, p. 53). The nation's monetary policy guidelines, which include currency and credit policies, are established by the President of the National Bank of Poland.

17. The banking system was first enlisted as a substitute, or supplementary, capital market mechanism, in November 1990 when shares in five large enterprises were offered for sale by the State Treasury. Some 200 banking outlets across the country were involved in this process - the two lead banks being the Polska Kasa Opieki, SA, and the Bank Slaski, assisted by the Wielkopolski Bank Kredytowy and the Bank Gdanski.

18. It was apparent during the first few hours after the banks opened for business that they were not equipped to handle the new type of activity. According to public complaints (Żychowicz, 1990), there were not enough windows open or personnel available, the number of copies of the prospectuses available was insufficient, people seeking information had to wait in the same lines as those seeking to subscribe, and the subscription process could take up to half an hour per client. Part of the slow tempo had to do with the means of payment, since a 20 per cent discount off share prices was given if payment was made with government bonds. This meant that the bank clerk had to determine the current market value of each bond offered, either by reference to a schedule or, if one were not available, by making a telephone call for assistance. Only about 11 per cent of the available shares were subscribed for during the first two days because of the slow service, and the subscription period had to be extended in December.

19. One of the privatizing companies, Exbud, displayed unusual initiative in getting around the administrative tangle (Żychowicz, 1990). It set up information centres in all 11 of its plants so that employees could both learn about the conditions for buying its shares and leave instructions for third persons to buy shares on their behalf. Not surprisingly, Exbud shares were the first to sell out.

20. It was six months before the next public share offer took place: that of the Swarzędz furniture factory in May 1991. Once again, the banking system was selected as the primary distribution channel, and it was evident from the speed with which the process took place that much had been learned from the earlier experiences. All available small lots (packets) of shares were subscribed for within the first 40 minutes.

II. PRIVATIZATION STRATEGIES USED IN POLAND

21. Poland's basic strategy to facilitate the entire privatization process and promote the selection of appropriate techniques is to sort State enterprises by size - that is, to use different methods and channels depending on whether enterprises are classified as large, medium, or small. A State enterprise leaves the State sector through one of two possible processes: transformation or liquidation. Transformation involves the legal reorganization of the enterprise into a private company without any winding-up stage in the process. Liquidation involves the winding-up of the enterprise before the State assets come under private ownership. The Government's 1991 programme (Monitor Polski, No. 13) is aimed at making conditions for speeding up privatization over the next five years favourable enough for Poland to achieve a level of private-sector participation in the economy comparable with that of the European Community.

A. Large enterprises

22. The transformation process is usually associated with large enterprises, and three main privatization techniques are contemplated for the 500 or so State enterprises classified as large. They are: sale by public share offer; private sale; and partial equity transfers by the State Treasury to investment groups known as National Wealth Management Funds (NWMFs).

23. Shares in the first five enterprises were offered for public sale at the end of November 1990, as described below, and a further three such offerings took place in the summer of 1991. The total should be brought up to 20 by the end of 1991 and will include between six and nine of the largest State enterprises in the country. A further 20 enterprises will be made ready for private sale to one or more investors, including foreigners. In addition, as an experimental approach, some 15 groups of enterprises will be privatized with a consulting firm or investment bank acting as a general coordinator.

24. To achieve large-scale privatization in a short time span, a strategy had been proposed to distribute free shares, in the form of privatization coupons,

in National Wealth Management Funds to adult Polish citizens (Bobinski, 1991). Although specific details have yet to be elaborated, the overall scheme is to create between 5 and 20 of such Funds, to be headed by Polish chairpersons and Polish Board representatives but to be operated by experienced Western managers from banks or investment funds. Equity in the 400 enterprises selected to be privatized in this fashion would be split three ways: 60 per cent would be transferred to the Management Fund, the State Treasury would retain a 30 per cent equity; and the remaining 10 per cent would be given to the employees of the particular enterprise. Trading in the Management Fund participation certificates - that is, shares - would be permitted, for both Polish citizens and foreigners, in early or mid 1993, after the companies held by the Funds had published their first full year's financial results.

25. The 400 or so enterprises selected for mass privatization play a significant role in the Polish economy, accounting for about 25 per cent of industrial sales and 12 per cent of employment. Because of the relatively short (three-year) period planned for completing the project, the Ministry of Ownership Transformations initiated various preparatory activities in the first half of 1991 so that implementation could get under way during the latter half of the year. These included (Monitor Polski, No. 43):

(a) Selecting the 100 enterprises considered to be the safest candidates for the first round;

(b) Preparing preliminary estimates for how successive privatization would be scheduled, while balancing the three main factors of the market, the State budget and the capital market;

(c) Defining the technical details and logistics of the bonus coupon scheme and how enterprise shares are to be allocated to the various National Wealth Management Funds;

(d) Mobilizing public opinion in favour of the concept of share ownership by the general public;

(e) Examining the potential for participation by Polish institutional investors such as banks, insurance companies and pension funds;

(f) Designing the conditions for creating and operating mutual funds with the participation of foreign capital and management, including defining their activities (such as issuing new shares, raising loans, and entering into various types of contracts) and how the funds are to be remunerated.

B. Small- and medium-sized enterprises

26. Although the Privatization Act was not passed until 13 July 1990, a considerable amount of small-scale privatization was carried out in advance. This was mainly effected through renting or leasing retail stores, owned by

the State, local governments, or cooperatives, under the provisions of the Business Premises Law of 10 April 1974, and by selling fixed assets (automotive equipment, in particular) under the State Enterprise Act of 26 September 1981. By the end of June 1990, some 12,000 of the 125,000 State and cooperative retail stores were being operated privately under rental or lease agreements. In the meantime, the State had sold off almost 500 retail stores, nearly 14,000 building sites, over 25,000 apartments, and various items of machinery and equipment (Baczynski, 1990).

27. The privatization tempo stepped up considerably after the political restructuring which occurred in June 1990. Newly constituted local governments were expected to live off their own resources, and thus were not provided with any start-up funding to cover their new financial responsibilities, which included, among other things, paying for local education and various public services. Almost immediately, local governments around the country started unilaterally terminating property rental agreements and started negotiating with the highest bidders. By the end of October 1990, some 50,000 retail units had changed into private hands. About 80 per cent of the retail trade was expected to be privatized by the middle of 1991, with complete privatization by the end of the year (Monitor Polski, No. 43).

28. Some 5,500 State enterprises fall into the categories of small and medium-sized: 2,500 are industrial enterprises, and about 3,000 are in other branches of the economy such as construction, transportation, trade, and tourism. The privatization techniques selected generally depend on the operating profile of the particular enterprise and the size of the market affected. While the transformation process has been more generally identified with large enterprises, commercialization - that is, liquidation - is planned to be used intensively, particularly for medium- and small-sized enterprises. It is anticipated that as many as 1,000 enterprises could be privatized in this way in 1991.

III. IMPLEMENTING THE PRIVATIZATION PROCESS

A. The Privatization Act

29. The Privatization Act of 13 July 1990 (Monitor Polski, No. 43) provides two main methods for transferring State enterprises into the private domain: transformation, and liquidation, also known as commercialization. Under the transformation approach, an enterprise is legally transformed into a private company subject to the Commercial Code with the State Treasury as sole shareholder. The State can then decide which of several options, individually or in combination, it will use to put some or all of its shares into private hands. These options include trade sale, public offer and management/employee buyout. Under the liquidation approach, the enterprise is liquidated in order to carry out certain planned privatization methods. These could include a sale or rental of the assets, a management/employee buyout, or the formation of a new company with domestic or foreign private participation with the State Treasury.

30. Shares may be sold in three ways: by auction, through a public offering, or by negotiation following a public invitation, unless the Council of Ministers approves some different method. The Minister for Ownership Transformations, with the approval of the Minister of Finance, specifies the financing principles for the sale of State-owned shares. Possible options are payment on the instalment basis (for Polish citizens) and payment with securities and/or cash. Restrictions are placed on direct or indirect ownership by foreigners. Offering shares whose par value exceeds 10 per cent of the share capital or offering privileged (preferred) shares to foreign parties or to legal entities or persons registered in Poland who are directly or indirectly controlled by a foreign party requires the approval of the president of the Foreign Investment Agency. These same restrictions apply should the Minister for Ownership Transformations decide to increase the share capital of a company owned exclusively by the State Treasury through an issue of new shares.

31. Employees of a transformed enterprise are entitled to buy up to 20 per cent of the total amount of the company's shares on a preferential basis. This privilege extends for a period of one year from the date that shares are made available for sale to employees. Employees may also acquire shares on the same terms as those available to non-employees. The preferential price of shares to employees during the entire one-year entitlement period is 50 per cent of the price set on the first day of sale for Polish citizens. The total value of the preferential discounts given to employees may not, however, exceed a certain monetary amount.

32. An innovative feature in the Act is the contemplated issuance of privatization coupons, free of charge and in equal amounts, to all Polish citizens resident in Poland. The coupons could be used in various ways to acquire State property - for example, to pay for shares issued by companies, to acquire an interest in mutual investment funds holding shares issued by companies, or to acquire enterprises or integrated parts of their assets, privatized through the liquidation approach.

B. Two models of privatization 4/

33. Because privatization can be implemented in various ways in Poland, attention is focused on the two approaches which attempt to incorporate socio-political goals into economic ones - namely, the management/employee buyout, and the public share offering.

1. The management/employee buyout

34. The Inowroclaw Meat Processing Plant was the first State enterprise to be privatized by means of a management/employee buyout. The privatization initiative came from the employees who, knowing that the enterprise was in good financial condition and operating profitably, wanted to take advantage of securing ownership for themselves while the opportunity existed. Another

deciding motive was the opportunity for pay increases, because under private ownership the company would not be subject to a tax on above-standard wages.

35. In June 1990, an application was submitted to the chief administrative officer of Bydgoszcz, where Inowroclaw is located, for privatization. Three months later, on 27 September, the Inowroclaw plant became one of the first seven enterprises to be transformed into a private company, solely owned by the State Treasury. While the other six were transformed into public corporations (spólka akcyjna = SA), the plant became a limited liability company (spólka z ogranicza odpowiedzialnościa = Sp.z o.o.). The State's next step was to place a value on the company.

36. At first, expert consultants, acting for the State Treasury, concentrated their attention on the financial condition, and preliminary figures of between 37 billion and 41 billion zlotys (then about $3.9-4.3 million) were provided. After the consulting firm had inspected the physical plant, including some buildings that were over 100 years old, the final amount arrived at was 30 billion zlotys (about $3.16 million). This was about six times the recorded book value of the property, and only the experts knew how it was calculated.

37. The accounting significance of the valuation question is the fact that, in some countries, property, plant and equipment are valued at historical cost. In periods of rising prices and where technical obsolescence is not a major issue, historical book value can be less than replacement cost. In Poland, on the other hand, revaluations of fixed assets have been required by the Government from time to time. The average revaluation of fixed assets taking effect on 1 January 1990 was 1,100 per cent, while the average rate which went into effect on 1 January 1991 was 260 per cent. It is conceivable, then, that the book value of the Inowroclaw plant's fixed assets could have been higher than replacement cost, because of the arbitrary nature of the period revaluations.

38. A second valuation issue is the way in which the enterprise is privatized. The privatization of Inowroclaw by transformation might have been more advantageous to the State Treasury, because it could command a "going-concern" price. Because of relatively small total capital and the purchase by one group - the workforce - the employees argued in favour of the liquidation approach which, by that time, was legally available.

39. The purchase agreement provided that 20 per cent of the total purchase price - that is, 6 billion zlotys - would be allocated to share capital. This represented 4,000 ordinary shares and 1,000 preference shares, carrying a 50 per cent discount, for a total of 5.4 billion zlotys in cash as a down payment. The remaining 24 billion zlotys was borrowed from the State Treasury through a five-year loan, secured by a mortgage on the fixed assets. The initial annual interest rate on the loan was 34 per cent. Within a month, the interest rate increased to 43 per cent, and by December it had climbed to 55 per cent. The average pay for a member of the workforce was about 800,000 zlotys, or just over $80 per month. So, the cost of one share, at

1.2 million zlotys, represented about six week's gross earnings, and most new shareholders went heavily into debt in order to invest.

40. One of the lessons to be drawn from this experience is that if the management/employee buyout technique is to be used to meet the socio-political goal of engaging the workforce in the economic process, then the financial terms have to be compatible with the circumstances in which the management and employees have to operate.

2. The public share offering

41. Privatization in Poland through public share offerings started in March 1990 when questionnaires were sent to State enterprises whose financial and economic data appeared promising. Talks were also held with management personnel, workers' councils, and potential domestic and foreign investors. As a result of these preliminary activities, 195 enterprises submitted information which went into the data bank at the Ministry for Ownership Transformations (Monitor Polski, No. 43, poz. 333, 2.1). The data was sorted according to various criteria - the three most important being interest to investors, support at the enterprise level for a privatization initiative, and lack of problems connected with legal ownership of the enterprise. By the end of October 1990, 20 enterprises had been transformed, and nine others were scheduled to be transformed.

42. The first public offering of shares took place on 30 November 1990. Details of the five companies and their capitalizations appear in table 1. The preparatory activities of the Ministry for Ownership Transformations included an extensive advertising and publicity campaign. The total issue price of all shares offered for sale was about 377 billion zlotys, or about $39.5 million. The estimated costs related to the public subscription, preparatory work on opening a stock exchange, and payment to consulting firms for their economic and financial analyses were between 4 and 5 per cent of the total offer price (Monitor Polski, No. 43, poz. 333, 2.1).

43. Share sales got off to a very slow start, and the subscription period had to be extended beyond the original deadline. This situation can be attributed to two main factors: the inadequacy of the banking system which served as a substitute for a securities exchange, and the general unfamiliarity of potential investors with a public share offering. Problems of introducing new investors to the world of finance were aggravated by accounting-related problems. In essence, almost no professional guidance was available concerning the potential risks and rewards of investing in any of the newly constituted SAs. Very elaborate prospectuses, prepared by Western consultants using unfamiliar formats for the balance sheets and income statements, proved more baffling than illuminating.

44. For some, reliance on rumour, intuition, or loyalty to the firm proved successful - that is, if they invested in Exbud, an early heavy favourite, or in the cable company SFK. As detailed in table 2, one of the SAs, the

Table 1. The first five large enterprises privatized through a public share offering

Name, activity and registration date	Capitalization	Number of shares offered	Nominal value per share (zlotys)	Issue price (zlotys)
Exbud S.A. Kielce (Construction company) 28 September 1990	1 million	450 000 (45%)	50 000	112 000
Slaska Fabryka Kabli, S.A. Czechowice-Dziedzice (Cable factory) 5 October 1990	1 million	830 000 (83%)	50 000	70 000
Krosnienskie Huty Szkla (KHS) Krosno, S.A. Krosno (Glass works) 15 October 1990	2.2 million	1.1 million (50%)	50 000	65 000
Próchnik, S.A. Lodz (Clothing manufacturer) 1 October 1990	1.5 million	1.2 million (80%)	50 000	50 000
Tonsil, S.A. Wrzesnia (Audio equipment manufacturer) 8 October 1990	1.5 million	750 000 (50%)	40 000	80 000

Source: Published prospectus for each company.

Table 2. Issue prices, price/earnings and price/book value ratios, and subsequent quoted prices for the first five large enterprises privatized through a public share offering

		Exbud	SFK	Krosno	Próchnik	Tonsil
1.	Book value a/ (millions of zlotys)	163 762	64 846	208 681	68 305	77 901
2.	Number of shares (millions)	1	1	2.2	1.5	1.5
3.	Book value per share (1 ÷ 2)	163 762	64 846	94 855	45 537	51 194
4.	Net income for 1990, annualized (millions of zlotys)	137 881	58 584	89 022	31 883	36 000
5.	Earnings per share (4 ÷ 2)	137 881	58 584	40 464	21 255	24 000
6.	Issue price per share	112 000	70 000	65 000	50 000	80 000
7.	Price/earnings ratio (6 ÷ 5)	0.8	1.2	1.6	2.4	3.3
8.	Price/book value ratio (6 ÷ 3)	0.68	1.08	.069	1.10	1.54
9.	Share price b/	196 000	80 000	56 500	41 500	56 000
10.	Price b/ as percentage of issue price (9 ÷ 6)	175	114	87	83	70

Source: Compiled from data contained in the published prospectus for each company (for items 1-8); Rzeczpospolita, 29-30 May 1991 (for item 9).

a/ Shareholders' equity.

b/ Quoted on 28 May 1991.

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price/earnings ratio of Exbud was the lowest of all five companies, and its shares have been in heaviest demand since the Stock Exchange opened in April 1991. Employees who bought shares at a 50 per cent discount in Exbud have had a happier experience than investors in Krosno, Próchnik and Tonsil, companies which are experiencing financial difficulties.

C. Difficulties in implementing privatization

45. The twin factors of political instability and critical economic conditions have left their mark in the slow rate of implementation of large and medium-sized enterprise privatization in Poland. If just one concern could be selected as characteristic of the current situation, it would be uncertainty.

46. Some two years have elapsed without a firm enunciation of industrial policy. So, with no clear notion of how or when their enterprises are to be privatized, managers are taking very short-run stances. As a recent study shows (Kotowicz, 1991), there are very few research and development programmes under way to adapt technologies in the country's failing industries so as to try and improve the economic picture. The fact that Western managers are being sought for large enterprises scheduled for transformation is yet another factor working against the motivation of Poland's professional managers.

47. As the economic recession deepens, the Government has increased problems by putting the best candidates forward first. It was almost six months before the next large enterprise, the Swarzedzkie Fabryki Mebli (Swarzędz Furniture Factories: SFM), was put on the market, because it first had to be restructured. The management was decentralized and production reorganized into differentiated plants specializing in the production of particular types of furniture. In addition, the State Treasury relieved SFM's balance sheet of a 64-billion-zloty debt (about $6.7 million). This meant that the company, transformed as Swarzędza SA, would be freed from the heavy burden of interest on the debt. This time, investor interest was very heavy, and small investors snapped up the allotted 900,000 shares, at 50,000 zlotys each, in the first 40 minutes that they were on sale. The State Treasury expected to realize a total of 70 billion zlotys on the offering, which it would keep for itself - earmarking 64 billion for repayment of the company's debt. It was then announced that a further 500,000 shares would be issued because of the excess demand and that this time the company would be permitted to keep the proceeds.

48. Several factors contributed to the success of this sixth offering. The company was very well known for its excellent furniture, most of which was exported for hard currency. Stock subscription arrangements were much better organized, and investors also knew that they would be able to trade their shares on the newly opened Securities Exchange. Thirdly, Exbud's success on the Securities Exchange created a market for potential investors. The Government could, therefore, congratulate itself on the outcome of the seven months of effort that it had put into the restructuring.

IV. IMPLICATIONS OF PRIVATIZATION FOR ACCOUNTING

49. There are three main types of accounting-related problems which have arisen during Poland's transition to a market economy. First, there are the difficulties of a fairly universal nature connected with valuation and pricing; these seem to take precedence in terms of concern. Then, there are the problems connected with shifting from fund accounting to commercial accounting. Thirdly, there are problems with the concept of internal and external financial control associated with the audit function.

A. Use of commercial accounting systems by State enterprises

50. In order to appreciate the problem of valuation, one has to understand the general structure of the accounting systems involved. In common with most of its post-socialist neighbours, Poland's State enterprises have used standardized charts of accounts for particular economic or industrial sectors, with double-entry bookkeeping. Using a fund approach, groups of assets (aktywa) on the balance sheet are identified with the sources of those assets (pasywa). This is the "cycle of activity" approach which underlies the general model of a Western audit. So, in a certain sense, the fund-based, integrated balance sheet could be viewed as having a more sophisticated structure than the typical corporate model in the United States and the European Community.

51. Until the new accounting law came into force on 1 January 1991, Poland used certain accounting practices which would not be considered generally acceptable. Fixed assets were periodically revalued, and earlier values were replaced in such a manner as to lose the audit trail. Also, the nature of the political/economic system had an impact on the valuation of current assets. Receivables, valued in the West at net realizable amounts, would be reversed against sales if payment were not made by 25 January of the following year. The lower of cost or market as a basis for valuing inventories was not an accepted accounting principle, because material prices were State-controlled. Land appeared on the balance sheet only if it had been purchased by the enterprise, which was legally possible in Poland. Depreciation was recorded using straight-line methods defined by the State.

52. The differences between Poland's accounting principles and those practised in the European Community have been largely eliminated in the new acccunting law. One significant factor in the law is, however, the lack of provision for inflation accounting, for Poland is now experiencing once again a sharp return to increasing price levels.

53. A major problem that Poland faces in implementing the new law is the training of its existing accounting and finance personnel. The Association of Accountants, with assistance from various sources, has been involved in a retraining process. This has largely taken the form of training classes for accounting instructors and special topic workshops for those employed in the

accounting and finance functions. Since all are very well acquainted with double-entry bookkeeping, one of the main areas of emphasis should be on the form and construction of the main financial statements, evaluation of financial condition, and other aspects connected with the financial management of a private company organized for profit.

B. Accounting and valuation processes

54. The extent to which accounting information may be used in the privatization process depends on the particular privatization technique involved. If an enterprise is to be privatized as a going concern, the use of a net discounted cash flow approach would probably be the preferred method. For various reasons, this technique is difficult to apply in Poland and other post-socialist countries for several reasons. Past profitability may be difficult to assess because of the widespread use of State-controlled prices and differences in accounting principles. Also, because the privatized unit will be operating in a very different environment - at least politically, if not economically - past history may not be a reliable guide to future prospects. Further, the discount rate may be extremely difficult to set in view of swings in interest rates and the perceived high level of risk. For all of these reasons, the use of some multiple of book value may also be questionable, although it benefits from being easily understood (except for how the multiple was selected) and it is widely acceptable to those who assume that book values approximate "real" values.

55. Book values in Poland, as elsewhere, may not faithfully represent past transactions, because some events may not have been recorded. This is a particular problem with respect to undisclosed liabilities for pensions, repair of environmental damage, and other issues which could have a significant financial impact. Because financial reporting has been an internal exercise, not subject to external review, certain accountability issues have not arisen in the past. Here, particular emphasis is on the concept of "substance over form", under which Western accounting practices follow the nature of a particular transaction rather than its legal form or structure. For example: leases which are, in substance, purchase agreements are usually capitalized under generally accepted accounting principles. Renting and leasing agreements have only lately assumed importance in Poland.

C. Presentation of accounting information in privatization

56. A number of problems connected with accounting and valuation processes may be better appreciated by reviewing certain aspects of the five privatization schemes carried out by transformation and public share offerings in November and December 1990.

1. Presentation of financial information

57. A review of the prospectuses leads one to concur with certain Polish observers (Czekaj, 1990) that Western-style presentation of data is not, at the present time, well adapted to the needs of new investors for information about the financial history, risks and prospects associated with privatized enterprises. This is because very little light is shed on the way in which inflation affects trends analysis; financial-statement format is largely unfamiliar; and the calculation of financial indicators is difficult and their use possibly misleading. This is because the underlying data was prepared in accordance with previous accounting laws not congruent with generally accepted accounting principles in market economies.

58. For example, financial data were presented in some detail for each of the three years 1987, 1988, and 1989, plus the partial year 1990 (the first six months for SFK, Krosno and Tonsil; the first eight months for Exbud; the first nine months for Próchnik). For each company, comparative inflation-adjusted sales figures were provided based on purchasing power at the date of the 1990 balance sheet. This enabled the user to calculate the magnitudes of the purchasing power adjustments and trace the sales trends, as shown in table 3.

59. Annualizing the partial 1990 sales data facilitated the analysis of sales trends. It shows that, in comparison with 1989, 1990 sales for Exbud and Tonsil were at about the same level, while 1990 sales for the other three companies were running about one third less than in the prior year. The magnitude of the purchasing power adjustments testifies to the hyperinflationary conditions. Intercompany differences in these magnitudes within the same years can be attributed to such factors as the choice of indexes or application methods, the composition of the sales, and whether the transactions were denominated in domestic or foreign currencies.

60. None of the companies described application methods, and only three of them identified their points of reference for inflation adjustments. Exbud referred to industrial price increases; Próchnik, a clothing manufacturer, stated that it used inflation statistics for the clothing industry supplied by the Chief Statistical Office; and SFK disclosed that it used internally generated price inflation indexes. Because there was no way to calculate the effects of inflation on other key amounts, such as cost of sales and net income, the value of presenting unadjusted prior years' data for purposes of assessing prior years' performance is questionable.

Table 3. Comparison of constant prices and current prices for 1987, 1988, 1989, and 1990 for the first five large enterprises privatized through a public share offering

	Exbud	SFK	Krosno	Próchnik	Tonsil
1987					
Constant price	345 087	424 485	552 116	219 778	228 568
Current price	11 467	6 793	12 511	7 092	8 109
Magnitude of adjustment	30.09	62.49	44.13	30.99	28.19
1988					
Constant price	413 839	436 964	689 801	233 871	258 739
Current price	21 974	13 773	21 740	11 344	14 231
Magnitude of adjustment	18.33	31.73	31.73	20.62	18.18
1989					
Constant price	743 502	430 503	848 127	226 542	268 578
Current price	130 426	42 776	67 355	36 444	50 517
Magnitude of adjustment	5.70	10.06	12.59	6.22	5.32
1990 a/					
Constant price	535 848	143 596	286 661	103 871	133 918
Current price	509 227	143 596	221 321	103 871	127 739
Magnitude of adjustment	1.05	1.00	1.30	1.00	1.05
Sales at constant prices, annualized	803 772	287 192	573 322	138 495	267 836
Annualized sales as percentage of 1989 sales (constant prices)	108.0	66.7	67.6	61.6	99.7

a/ For SFK, Krosno and Tonsil: 6 months of data; for Exbud, 8 months; Próchnik, 9 months.

/...

2. Inflation and revaluation effects

61. The effects of inflation on balance sheet items, on the other hand, is to some extent reflected in the book values (that is, amounts net of depreciation) of fixed assets. In Poland, all State enterprises are periodically required to revalue fixed assets, using uniform percentage rate increases depending on the particular asset category or group. Depreciation on revaluation increases is calculated, and accounted for, in the same way as depreciation on historical cost. In most Western countries, fixed assets are accounted for at their historical cost, and revaluation is not a generally accepted accounting principle. There have been, as mentioned above, two recent revaluations in Poland. As shown in table 4, revaluations had the greatest impact on the net book values of fixed assets for Krosno and Próchnik.

62. Despite the hyperinflationary conditions, Poland's new accounting law, which went into effect on 1 January 1991 (Dziennik Ustaw No. 10, poz. 35), does not contain any provisions for inflation accounting. Subsequent legislation passed on 29 July 1991 (Dziennik Ustaw No. 71, poz. 308), governing the prospectus for an issue of securities to the public, contains only one reference to inflation-adjusted financial information (para. 11.7):

> If the last three years of the issuer's activities fell in a period of large-scale inflation (higher than an annual rate of 20 per cent), the financial data (at least with respect to sales value) should be adjusted by an inflation index with disclosure of the source of the index and method of application.

63. This clause formalizes the practices which were followed in the prospectuses for the five companies privatized in December 1990. That is, only the minimum data, the sales figures, were inflation-adjusted. The above paragraph, however, fails to take into account the recommendations of the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting. 5/ In view of the distortions of financial condition and financial results reported on a historical cost basis under inflationary or hyperinflationary conditions, the new regulations governing financial reporting appear to require amendment.

64. The potential investor is, of course, interested in which of the offered stocks would be a "best buy" - that is, which have the best potential for generating future income so as to offer opportunities for dividends and profit on resale of shares.

Table 4. Effects of revaluations on the net fixed assets of the first five large enterprises privatized through a public share offering

(Millions of zlotys)

Company	Partial period ended	Net book value of fixed assets	Revaluation amounts included in net book value	Revaluation as a percentage of net book value
Exbud	31 August 1990	71 659	21 808	30
SFK	30 June 1990	27 199	12 217	45
Krosno	30 June 1990	134 364	126 610	94
Próchnik	30 September 1990	27 857	23 930	86
Tonsil	30 June 1990	65 383	41 947	64

Source: Compiled from data in the prospectus for each company.

3. Evaluation of share offer prices

65. As has been shown above, few of the historical, statistical data provided are useful for the potential investor. The comparative data for prior years which are used in the West for trend analysis are not adjusted for the effects of inflation. Further, a critical assumption when incorporating historical data into the future-oriented decision process is that the past provides a reasonable basis for predicting the future. This does not hold in the Polish case, because a company newly formed out of a State enterprise will be operating in a completely different environment. This situation was pointed out in the prospectuses in narrative descriptions of the various risks the enterprises face. Since this qualitative information is not quantified, the investor has to rely heavily on intuition or luck. However, it would be helpful to know how the shares were priced. This is not disclosed anywhere. One can, however, evaluate the offered prices using two widely used statistics: the price/earnings ratio, and the ratio of offer price to book value. These were calculated in table 2, using annualized income for 1990 to calculate the price/earnings ratio.

66. The price/earnings ratio is calculated by dividing the offer price per share by earnings per share. It shows how many years of earnings an investor is paying for when buying a share. The lower a firm's potential for growth, the lower the ratio. So, a well-established company without expectation of

significant increases in annual earnings per share, for example, will not command a high price/earnings ratio. Companies with high potential for increased earnings will, all other things being equal, command a higher price/earnings ratio. In 1988, the price/earnings ratio for the Ford Motor Company was 5. Investors will be willing to pay for more years of current earnings on the assumption that the value of their purchased shares will rise as the company becomes more profitable. So, several factors affect differences between the price/earnings ratios of different companies. They include the trends in, and stability of, a company's earnings, relative risks, and perceived growth potential.

67. The price/earnings ratios for the large five companies privatized in Poland were very low indeed, even though the ratios are understated, because annualized earnings may have overstated the 1990 income. For Exbud, for example, the offer price was only just over 80 per cent of the 1990 earnings on an annualized basis. Under Western standards, and all other things being equal, the stock is very much underpriced or its future prospects are very poor. The Próchnik and Tonsil shares were the only ones requiring investors to pay for more than two years' earnings.

68. The book value per share is calculated by dividing the shareholders' equity, or "own capital", as expressed in Poland, by the number of common shares outstanding. The book value is most relevant when the net assets (that is, total assets minus total liabilities) are shown on the balance sheet at or near their market values. The book value per share would then indicate the amount that shareholders would expect to receive if the company were liquidated in the near future. In countries where balance sheets show historical costs, market values would probably be higher than book values in periods of rising prices. As pointed out above, the Polish revaluations of fixed assets have probably resulted in some correction for the effects of inflation on balance-sheet items.

69. Some financial analysts will recommend shares with market prices lower than book values as "good buys", particularly if book values reflect market values and there is either a short-run perspective or the prospect of the company breaking up, for example. One could expect market values to exceed book values in the long run, since the intangible asset of earning power (goodwill) is not booked unless purchased. From this standpoint, Exbud and Krosno, with offering prices of 68 and 69 per cent, respectively, of their book values, are "best buys". Kabel (SFK) and Próchnik are just about at par, with Tonsil at about one and one-half times book value. (These statistics can only add to the bitterness at Inowroclaw where the employees were charged six times book value for their shares.)

Notes

1/ The dividend is, in essence, a charge for the use of State-provided property. It is calculated at 32 per cent per year of the book value of certain fixed assets, contributed by the enterprise's founding body, as of the end of 1983. Because of the major, and arbitrary, revaluations carried out in 1989 and 1990, the amount of the dividend increased significantly. It is payable monthly, regardless of financial results.

2/ Commercial Code, 27 June 1934; Act Relating to Economic Activities of Foreign Entities, 14 June 1991; Banking Act of 31 January 1989; and Act of Privatization of State-owned Enterprises, 13 July 1990.

3/ This section is drawn from Tarnowski (1991) and Zukowska (1991).

4/ This section is drawn from Niedosug (1990) and Tarnowski (1990).

5/ "Accounting for inflation and changing prices and market and historical values of assets and liabilities", International Accounting and Reporting Issues: 1989 Review (United Nations publication, Sales No. E.90.II.A.4).

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PROGRAMME OF WORK OF THE INTERGOVERNMENTAL WORKING GROUP OF EXPERTS ON INTERNATIONAL STANDARDS OF ACCOUNTING AND REPORTING: DISCUSSION OF ACCOUNTING ISSUES ARISING DURING PRIVATIZATION, INCLUDING INDIVIDUAL COUNTRY CASE-STUDIES

Accounting problems arising during privatization in the United Kingdom of Great Britain and Northern Ireland

Report of the Secretary-General

SUMMARY

Public industrial enterprises became a substantial part of national output and investment in the United Kingdom following the Second World War. In the 1960s and 1970s there was a significant decline in the economy. By the 1980s, the mood of the Government was for change, and a programme to improve the performance of many of the public industrial enterprises was undertaken. The programme included deregulation by opening the industrial sector to competition from the private sector, and denationalization by floating large share offerings to the public. Because national and international capital markets are highly developed in the United Kingdom, flotation of these shares created no significant problems for the Government. However, because one of

* E/C.10/AC.3/1992/1.

its objectives was widespread ownership, an extensive promotional campaign was undertaken. In order successfully to accomplish the offerings, it was necessary for the Government to provide for substantial restructuring of debt and to assume restructuring costs and pension liabilities to make the privatized enterprises economically viable. Accounting problems were experienced when only part of a state entity was selected for privatization. Allocation of revenues and costs between appropriate accounting periods became a matter for careful analysis. Adequate bookkeeping records frequently were not available. Also, when normal commercial standards were applied to the valuation of assets, adjustments were necessary to change depreciation lives, write-off some past expenditures, and capitalize others.

CONTENTS

		Paragraphs	Page
I.	OBJECTIVES OF PRIVATIZATION	1 - 16	4
	A. Improving enterprise efficiency	2 - 6	4
	B. Improving the Government's financial and operating circumstances	7 - 12	6
	C. Expanding popular support for shareholding	13 - 16	9
II.	PRIVATIZATION METHODS USED IN THE UNITED KINGDOM	17 - 23	10
III.	IMPLEMENTING THE PRIVATIZATION PROCESS	24 - 42	16
IV.	ACCOUNTING IMPLICATIONS OF PRIVATIZATION	43 - 58	21
	A. Accounting in the nationalized industries	43 - 51	21
	B. Accounting and valuation processes	52 - 58	24
References			27

I. OBJECTIVES OF PRIVATIZATION

1. The privatization programme of the United Kingdom of Great Britain and Northern Ireland, inaugurated in 1979, rested on two primary and traditional objectives which linked micro-economic and macroeconomic policy: to improve the economic performance of the nationalized industries by placing them under private ownership; and to increase the efficiency of the nation's economic system by restoring market mechanisms and reducing state intervention in economic affairs. Secondary objectives, some of which emerged after privatization activities got under way, were to ease constraints on the State's budget, expand popular support for share-holding, promote participation by the workforce in enterprise capital, and reduce the power of the unions (Santini, 1986, pp. 33-44).

A. Improving enterprise efficiency

2. During the 1960s, the nationalized industries were in a state of decline both economically and financially. This was partly due both to poor domestic conditions generally, as well as a world-wide depression in certain sectors such as the iron and steel industries and shipbuilding. Studies showed that nationally, privately owned enterprises were outperforming their public counterparts. Internationally, the United Kingdom's nationalized industries had poorer results than foreign industries in the same economic sectors (Santini, 1986, p. 34).

3. Other reasons for poor operating performance by the nationalized industries could be attributed to certain government policies. Prices in the nationalized sector had been frozen or controlled in the late 1960s as an anti-inflationary measure. Enterprises had been required to regroup, or undertake to engage in certain acquisitions, for job-conserving purposes, limiting their ability to diversify or otherwise pursue favourable opportunities. Also, procurement policies and commercial relationships were restricted in order to protect the domestic market or to support certain suppliers.

4. By 1975, the number of public corporations had grown to almost 50. They were engaged in very diverse activities, dominating four strategic sectors of the economy: iron and steel, energy, public transportation, and communications. In the aggregate, these industries accounted for 19 per cent of total fixed investment in the United Kingdom, employed 8 per cent of the workforce, and contributed 11 per cent of gross domestic product (National Economic Development Office, 1976b, p. 11). A significant proportion of public-sector performance was, however, attributable to just nine major nationalized industries, as shown in table 1.

Table 1. Role of public corporations in the economy of the United Kingdom, 1975

	Percentages of totals		
	Output	Employment	Fixed investment
Major nationalized industries			
British Airways	0.3	0.2	0.4
British Gas	0.8	0.4	1.7
British Rail	1.2	1.0	1.0
British Steel Corporation	0.8	0.9	2.0
Electricity (England & Wales)	1.5	0.7	2.9
National Coal Board	1.5	1.2	0.9
Post Office	2.8	1.8	4.5
National Bus	0.2	0.3	0.1
National Freight Corporation	0.2	0.2	- a/
Total	9.2	6.7	13.6
Other nationalized industries	0.4	0.2	0.8
Total, nationalized industries	9.6	6.9	14.4
Other public corporations	1.4	1.1	4.6
All public corporations b/	11.0	8.0	19.0

Source: National Economic Development Office, A Study of U.K. Nationalized Industries. Appendix volume (London, Her Majesty's Stationery Office, 1976), p. 11.

a/ Less than 0.05.

b/ Totals may not add, due to rounding.

5. Five of these nine industries - British Gas, British Rail, Electricity, the National Coal Board, and the Post Office - enjoyed an effective monopoly for most of their output. British Steel accounted for about 90 per cent of the crude steel supply in the United Kingdom, but it also competed in the international markets, as did British Airways. Except possibly for the Post Office, some competition did exist domestically by way of imports or alternative goods or services. Expenditures on plant and equipment by six of the nine major nationalized industries referred to above equalled almost one third of all capital goods' purchases by United Kingdom industries. As a result of this massive purchasing power, concentrated in a small range of sectors and involving specialized technologies, various suppliers became captive to the capital investment policies of these relatively few nationalized industries. In certain instances, therefore, market power was both horizontal and vertical (National Economic Development Office, 1976a, p. 14).

6. Following an investigation into capital investment procedures by the Select Committee on Nationalized Industries in 1973, the Government asked the National Economic Development Office (NEDO) to carry out a wide-scale review of the economic role of the nationalized industries and future directions for their control. This study was completed in 1976 (NEDO, 1976a). NEDO's report contained a study by a management consulting firm which reviewed the pricing policies, investment criteria, and financial objectives of four nationalized industries: British Gas Corporation, British Railways Board, British Steel Corporation, and Post Office (Telecommunications). It found a lack of relevance in competitive markets; lack of definition of the standards of service which the industries were expected to deliver; the need to pursue noncommercial service objectives; pricing, or investment policies, which resulted in adverse financial results, and a general limitation on the ability of financial objectives to promote efficiency in a nationalized industry.

B. Improving the Government's financial and operating circumstances

7. Public policy favoured debt financing as the basic financial structure for the nationalized industries right from their inception. At the time of nationalization, the value of the assets vested in the public corporation was accounted for as a loan to be repaid to the Treasury, at prevailing interest rates, in accordance with the time period specified in the legislation. Thereafter, almost all funding took the form of long-term loans from the National Loans Fund administered by the Treasury. The loan periods were determined by the average estimated asset life in each nationalized industry. Industries were also able, with government permission, to borrow on the domestic or overseas capital markets. Because the Government usually guaranteed repayment, such loans were also considered to constitute government borrowings (Likierman, 1979, p. 9).

8. A small number of the industries, such as British Airways, British Steel, and the Post Office Giro, also had financing in the shape of Public Dividend

Capital (PDC), a form of share capital, on which a dividend was payable to the Treasury. The industry's cash limit, referred to above and known as the external financing limit after 1978, was composed of public dividend capital, net borrowings, grants, and leasing. Leasing was included to preclude its misuse by industries as a loophole for violating cash limits.

9. Three main sources of funds were generally available to public corporations to finance their working capital and fixed asset investment needs: internal funding, revenue subsidies and government compensation payments, and borrowings from Government. During the 1960s the relative proportions of total funding attributable to these sources were fairly stable: between 25 and 45 per cent coming from internal funding, 10 per cent from subsidies and compensation, and the remainder from borrowings. A considerable shift in this profile took place in the early 1970s, as detailed in tables 2, 3 and 4.

Table 2. Sources of funds and government revenue support for nine major nationalized industries, 1969-1974 a/ (percentages)

	1969	1970	1971	1972	1973	1974
Internal funding before subsidies/compensation	53	41	41	41	24	17
Government subsidies, compensation etc.	8	6	12	7	39	32
Subtotal	61	47	53	48	63	49
Net increase in borrowings from Government and capital transfers	45	41	51	53	6	24
Net increase in other borrowings	-6	12	-4	-1	31	27
Total sources of funds	100	100	100	100	100	100

Source: National Economic Development Office, A Study of U.K. Nationalized Industries. Appendix volume (London, Her Majesty's Stationery Office, 1976), p. 70.

a/ In the case of six of the nationalized industries, data relate to financial periods ending March in the year following that indicated in the column headings.

Table 3. Capital write-offs and government revenue support for nine major nationalized industries

(Millions of £)

	1963-1968	1969-1974	1963-1974
Revenue subsidies and compensation	853 a/	2 565	3 418
Write-offs of government loan capital against revenue deficits etc.	535 a/	2 194	2 729 a/
Total government financial support of a revenue nature	1 388 a/	4 759	6 147 a/
Internal funding (before subsidies)	3 143	4 043	7 186

Source: National Economic Development Office, A Study of U.K. Nationalized Industries. Appendix volume (London, Her Majesty's Stationery Office, 1976), p. 71.

a/ Excludes £130 million revenue grants and £487 million capital write-offs in 1963 for British Transport Commission, which are properly attributable to the pre-1963 period.

Table 4. Summary of net revenue payments to and receipts from the Exchequer for nine major nationalized industries

(Millions of £)

	1963-1968		1969-1974	
	Interest, tax, dividends to Government	Revenue subsidies and capital write-offs	Interest, tax, dividends to Government	Revenue subsidies and capital write-offs
British Rail & NCB	507	1 256 a/	363	3 046
7 other nationalized industries	1 365	132	3 534	1 713
Total for 9 major nationalized industries	1 872	1 388	3 897	4 759

Source: National Economic Development Office, A Study of U.K. Nationalized Industries. Appendix volume (London, Her Majesty's Stationery Office, 1976), p. 74.

a/ Excludes £130 million revenue grants and £487 million capital write-offs re British Transport Commission.

10. For the nine major nationalized industries in aggregate, the internal funding contributions slipped from a level of 53 per cent in 1969 to about 17 per cent in 1974. Government subsidies and compensation went from 8 per cent to 32 per cent, while borrowings went from 30 per cent to 51 per cent. These statistics were influenced particularly by very poor financial performance from British Rail and the National Coal Board.

11. Subsidies and compensations were not the only form of government revenue support. As detailed in table 3, over £2.7 billion in capital debt was written off for five of the nine major industries. The remaining four - Electricity, British Gas, National Bus, and National Freight Corporation - did not have capital debt write-offs, but the two latter industries had accumulated revenue deficits at the end of 1974 and 1975 (NEDO, 1976b, p. 71).

12. The net revenue burden on the exchequer, detailed in table 4, went from a net £484 million excess of inflows over outflows for the period 1963-1968 to a reverse situation for 1969-1974, when outflows exceeded inflows by £862 million. Here the drain on the public finances by British Rail and the National Coal Board is very evident. At the end of the 1970s, privatization became the political choice for easing the public-sector borrowing requirements.

C. Expanding popular support for shareholding

13. The notion of building up popular capitalism through encouraging share ownership by the general public was an objective which emerged after the privatization movement got underway at the beginning of the 1980s and shares in privatized companies had been offered for sale.

14. The twin aims of increasing fiscal viability in government and decreasing its role in economic affairs were concentrated on activities at the local government level. Privatization's main beginnings were in the highly successful sales of council houses to their tenants, involving over a million transactions by the mid 1980s and the contracting-out of some local services.

15. As the Government began to appreciate the general public's potential as a source of investment funds, the privatization rhetoric shifted its emphasis from the benefits for business efficiency to popular capitalism. John Moore, the minister responsible for privatization, expressed it this way in 1986 (Letwin, 1988, pp. 27-28):

> Our programme, which is already succeeding even beyond the dreams of the optimists, is directed towards the three key areas of life: homes, work-places, and the wider community. We are extending home ownership,

increasing employee participation in the ownership of their companies and spreading the ownership of public companies to millions of ordinary people.

16. The Government went to some considerable lengths to encourage employee share participation, as described below, achieving some notable successes.

II. PRIVATIZATION METHODS USED IN THE UNITED KINGDOM

17. The United Kingdom's privatization programme consisted essentially of three interrelated approaches: deregulation, denationalization, and contracting-out. Deregulation, or opening up activities controlled or dominated by the State to private-sector competition, has, for the most part, been attempted through denationalization - that is, the sale of publicly owned assets, which is the dominant privatization strategy. Contracting-out, or competitive tendering, while on the rise and in some circumstances required by law, has not yet found overall application to any significant extent in the United Kingdom.

18. The various denationalization and deregulation approaches used to date were selected from the viewpoints of both overall policy objectives and the prevailing circumstances. As detailed in tables 5, 6 and 7, public share offerings, yielding the Government over £26 billion in gross proceeds, have been the preferred method of selling state assets, followed by management/employee buyouts and trade sales.

19. Public offerings were a logical first choice for several reasons. Expediting the privatization programme and expanding public ownership of shares were important goals, and large sums of money were involved.

20. The United Kingdom's developed domestic and international capital markets and relative abundance of available capital made it possible for the Government to evaluate the various ways of disposing of national assets. However, ways had to be devised to encourage and assist purchases by small, and probably naive, investors in a country where, in 1981, less than 4 per cent of the population owned shares, as compared with about 19 per cent, for example, in the United States (Santini, 1986, p. 41). These techniques took the form of widespread and comprehensive publicity campaigns and special financing arrangements. Campaigns to advertise share offerings were very extensive, covering most - if not all - the media, and with special coverage for professionals such as accountants and bankers most likely to influence investment decisions.

Table 5. Privatization through public share offerings, 1977-1988

	Sale date	Percentage sold a/	Gross proceeds (millions of £) Company	Government	Total
British Petroleum	June 1977	17.0	-	564	564
	Nov 1979	5.0	-	290	290
	Sept 1983	7.0	-	566	566
	Oct 1987	36.8	1 515	5 502	7 017
		65.8	1 515	6 922	8 437
British Aerospace	Feb 1981	51.6	100	50	150
	May 1985	59.0	188	363	551
		110.6	288	413	701
Cable & Wireless	Oct 1981	50.0	35	189	224
	Dec 1983	22.0	-	275	275
	Dec 1985	31.0	331	602	933
		103.0	366	1 066	1 432
Amersham International	Feb 1982	100.0	6	65	71
Britoil	Nov 1982	51.0	-	549	549
	Aug 1985	48.0	-	449	449
		99.0	-	998	998
Associated British Ports	Feb 1983	51.5	56	(34)	22
	Apr 1984	48.5	-	52	52
		100.0	56	18	74
Enterprise Oil	June 1983	100.0	-	392	392
Jaguar	July 1984	99.0	-	294	294
British Telecom	Nov 1984	50.2	1 290	2 626	3 916
British Gas	Dec 1986	97.0	(2 286)	7 720	5 434
British Airways	Feb 1987	100.0	-	900	900
Rolls-Royce	May 1987	100.0	283	1 080	1 363
BAA	July 1987	100.0	-	1 281	1 281
British Steel	Dec 1988	100.0	-	2 500	2 500
Total			1 518	26 275	27 793

Source: Peter Temple, "Asset stripping by decree?", Accountancy (November 1989), p. 80.

a/ The percentage of shares sold may not total 100, due to rights issued and shares retained for loyalty bonus or employees.

Table 6. Special arrangements for employees of certain privatized industries

	Free shares (per employee)	Matching shares (per employee)	Priority shares		Employees participating (percentage)
			Each	Percentage of total	
Amersham International	35	350	a/	5	99
Associated British Ports, 1983	53	225	a/	3	90
1984	-	-	1 000	-	-
BAA	41	82 b/	4 802	5	n/a
British Aerospace, 1981	33	600	a/	2.5	74
1985	-	-	10 000	2	-
British Airways	76	120 a/	a/	9.5 c/	90
British Gas	52	111 a/	20 000	5 b/	99
British Petroleum, 1979	-	137	137	-	43
1983	-	-	250	-	-
1987	-	-	1 000	-	-
British Telecom	54	77 a/	a/	10 c/	96
Britoil, 1982	28	186	11 500	-	72
1985	-	-	10 000	3	-
Cable & Wireless, 1981	d/	-	a/	5	99
1983	-	-	1 000	-	-
1985	-	-	5 000	1	-
Enterprise Oil	-	-	13 500	-	71
Jaguar	-	-	10 000	7.5	19
Rolls Royce	41	88 b/	5 882	5 c/	..

Source: Howard Hyman, Privatization: the facts. In Privatization and Competition. C. Veljanovski, ed. (London, Institute of Economic Affairs, 1989), p. 205.

a/ No limit.

b/ The Government matched each share purchased with a further 2 shares.

c/ Also 10 per cent discount on up to 1,600 shares (British Airways and British Telecom), 1,481 shares (British Gas) and 1,176 shares (Rolls Royce) per employee if held until final instalment paid.

d/ 285,833 were made available free of charge to the trustees of the Employee Share Schemes.

Table 7. Privatizations through management/employee buy-outs and trade sales, 1979-1989

		Gross proceeds (millions of £ sterling)		
		MBO	Trade sale	MBO/TS
British Shipbuilders				
Warship Yards				
Brook Marine	May 1985	0.1		
Yarrow Shipbuilders	June 1985		34.0	
Vosper Thornycroft	Nov 1985	18.5		
Swan Hunter Shipbuilders	Jan 1986	5.0		
Hall Russel	Mar 1986		..	
Vickers Shipbuilding & Engineering	Mar 1986	60.0		
Scott Lithgow	Mar 1984		12.0	
Govan Shipyard	Aug 1988		..	
Clark Kincaid Ltd.	Dec 1980		..	
Appledore Shipbuilders Ltd.	Jan 1989		..	
British Technology Group (NEB)				
ICL	Dec 1979		37.0	
Fairey	June 1980		15.0	
Ferranti	July 1980		43.0	
Inmos	Aug 1984		95.0	
National Bus Company	Aug 1986-Mar 1988			325.0
National Freight Company	Feb 1982	7.0		
Rover Group				
Unipart	Jan 1987	30.0 a/		
Leyland Bus	Jan 1987	4.0		
British Leyland Trucks	Apr 1987			
DAB	May 1987	7.0		
Istel	June 1987	26.0		
British Rail				
British Rail Hotels	Mar 1983		45.0	
Sealink	July 1984		66.0	
Doncaster Wagon Works	Oct 1987	..		
Horwich Foundry	Aug 1988		2.0	
Travellers Fare	Dec 1988	21.0		
British Rail Engineering Ltd.	Apr 1989			14.0

/...

Table 7 (continued)

		Gross proceeds (millions of £ sterling)		
		MBO	Trade sale	MBO/TS
British Airways				
International Aeradio	Mar 1983		60.0	
British Airways Helicopters	Sept 1986		14.0	
British Gas Wytch Farm	May 1984		80.0 a/	
Royal Ordnance				
Leeds tank factory	Oct 1986		15.0	
Remainder	Apr 1987		190.0	
Rover Group	Aug 1988		b/	
Yorkshire Rider	Oct 1988	23.0		
National Seed Development Organization	Sept 1987		66.0	
General Practice Finance Corporation	Mar 1989		145.0	
Busways	May 1989	14.0		
Short Brothers	June 1989		30.0	
Redpath Doman Long	May 1982		..	
Incomplete total		215.6	949.0	339.0

Source: Peter Temple, "Asset stripping by decree?", Accountancy (November 1989), p. 81.

a/ Initial proceeds only; additional proceeds contingent on future activity for Vickers (£40 million), Unipart, and Wytch Farm (£135 million plus profit share).

b/ Trade sale after cash injection of £547 million.

Note: MBO Management buy-out (including management/employee consortia)
MBO/TS Combination management buy-out and trade sale

21. In 1984, Samuel Brittan addressed the question of public equity rights in state-owned assets turned over to private ownership and suggested free distribution of shares to all adult citizens as well as providing the work force with shares in their own industries (Pliatzky, 1985, p. 47). The first proposal is now under serious consideration in Eastern Europe; the second had already been considered in some of the special arrangements for small investors and employees. The main financial encouragement to the small investor was to provide for instalment payments, usually two or three spaced some months apart. In addition, two inducements to longevity in shareholding were offered in some privatizations: loyalty bonus shares and vouchers. The former represented one free share for every 10 held for at least three years. The voucher scheme, offered by British Gas and British Telecom, allowed customers to take discounts from their billings by those companies after a six-month holding period.

22. In order to meet the goals of providing a wider spread of equity ownership, particularly in the workforce, special consideration was given to the possibilities of using the management/employee buy-out technique. The term "management/employee buy-out" refers to the purchase of a controlling interest in a privatized company by managers and/or employees. The technique is most appropriate when the amounts involved are within the financial capacity of the individuals involved, financing terms can be arranged, and the potential cash flows of the company are estimated to be adequate to meet the debt service requirements. Table 6 shows special incentives that were given to employees of certain United Kingdom enterprises that were privatized.

23. A trade sale is a private sale of government-owned assets to another company or investor. The assets can be sold separately or as a group, so a trade sale is a convenient mechanism to use in the case of downsizing or splitting off. Those fragmented units of the former British Shipbuilders which were not bought out by the management and employees, for example, were disposed of by trade sales. The split-off British Rail hotels were sold to private parties or auctioned off, and Sealink was sold through competitive bidding. Table 7 provides a listing of management buy-outs and trade sales in the period from 1979 through 1989.

III. IMPLEMENTING THE PRIVATIZATION PROCESS

A. The privatization model

24. The planning and control of a privatization model action in the United Kingdom generally follows the three main preparatory stages diagrammed in figure I, even though a variety of possible implementation techniques and strategy options may be available.

25. Common to all of these approaches is the fact that many state-owned activities are public corporations. In order to privatize them by share sales, the predominant technique in the United Kingdom, it is necessary to legislate the creation of a public limited corporation (PLC) to which the assets can be legally transferred. Shares in the new company are held by the relevant Secretary of State and are then transferred by sale to the new owner. As a consequence, there is no general privatization law, since legislation is specific.

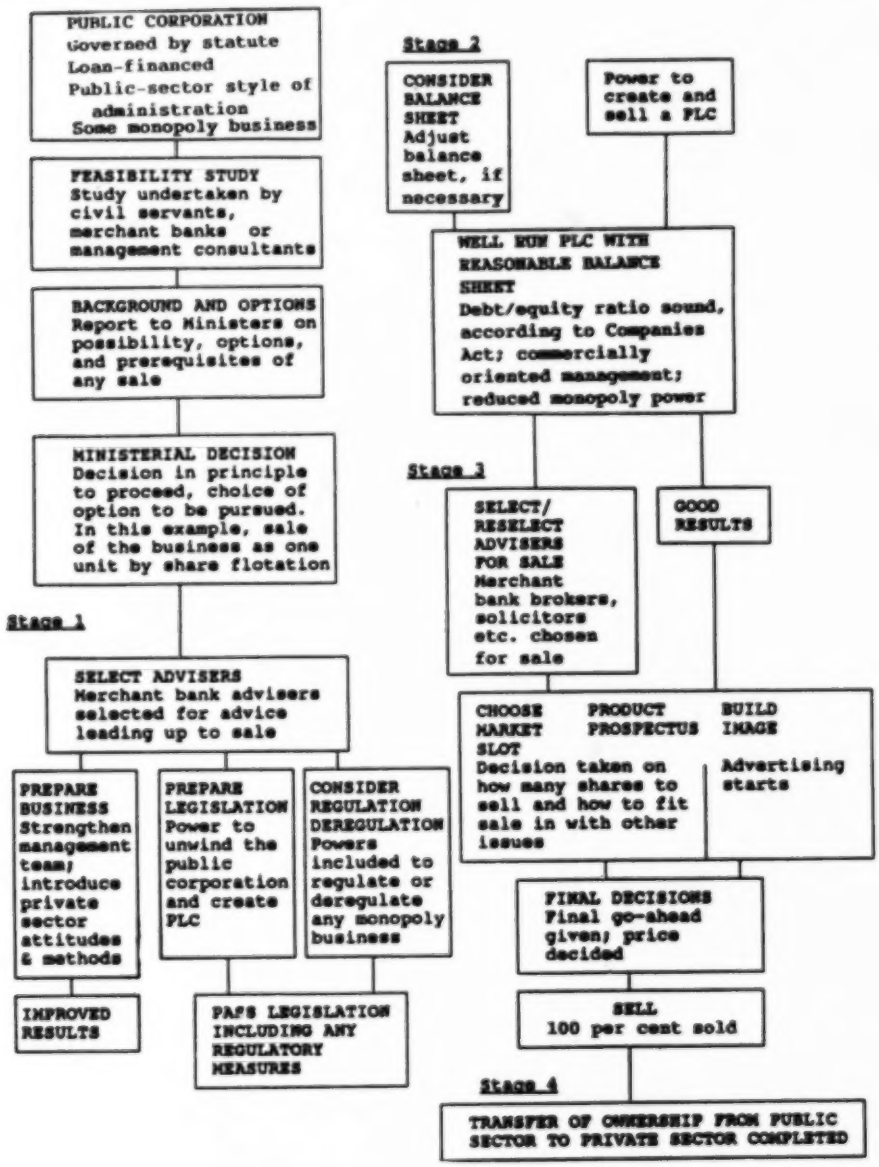
26. Briefly summarized, the general procedure in a share flotation is to commission a feasibility study, followed by a report back to the Minister on the background and options available. The Minister then makes a decision as to how the privatization is to proceed. The activity goes forward in three stages: readying the corporation for the private sector; carrying out any final financial restructuring before getting the state-owned but commercial law company into operation; and putting the company shares on sale.

27. A special feature of certain privatizations in the United Kingdom is the so-called "golden" share (which has been adopted and adapted by other countries). This is a special share created in the enabling legislation to give the government owner certain defined rights, because the company is of strategic importance or the national interest otherwise calls for some degree of government control. In the case of Sealink, which was a trade sale, as described above, the Government invoked the golden share, because a foreign company won in the competitive bidding (Vuylsteke, 1988, p. 165). In this instance, the special provisions enabled the Government to attend and speak, but not vote, at the annual meeting; veto the total liquidation of the company; veto the disposal of an important part of the fleet (25 per cent of the book value) and the right to check that the fleet could be used for purposes of national defence; and restrict one shareholder from owning more than 75 per cent of voting shares (Santini, 1986, p. 59).

28. The processes of privatizing British Telecom (BT), described below, illustrate a public share offering. BT was the first very large corporation sold in this way and some valuation issues arose, as described in section IV. Further, the Government benefited from its experiences with this exercise when floating other companies.

29. BT was established as a public corporation under the British Telecommunications Act of 1981, when it was split off from the Post Office, with exclusive rights to operate public networks and regulate the industry.

Figure I. Typical processes of public corporation privatisation through share flotation in the United Kingdom


PUBLIC CORPORATION
Governed by statute
Loan-financed
Public-sector style of administration
Some monopoly business
FEASIBILITY STUDY
Study undertaken by civil servants, merchant banks or management consultants
BACKGROUND AND OPTIONS
Report to Ministers on possibility, options, and prerequisites of any sale
MINISTERIAL DECISION
Decision in principle to proceed, choice of option to be pursued. In this example, sale of the business as one unit by share flotation
Stage 1
SELECT ADVISERS
Merchant bank advisers selected for advice leading up to sale
PREPARE BUSINESS
Strengthen management team; introduce private sector attitudes & methods
PREPARE LEGISLATION
Power to unwind the public corporation and create PLC
CONSIDER REGULATION DEREGULATION
Powers included to regulate or deregulate any monopoly business
IMPROVED RESULTS
PASS LEGISLATION INCLUDING ANY REGULATORY MEASURES
Stage 2
CONSIDER BALANCE SHEET
Adjust balance sheet, if necessary
Power to create and sell a PLC
WELL RUN PLC WITH REASONABLE BALANCE SHEET
Debt/equity ratio sound, according to Companies Act; commercially oriented management; reduced monopoly power
Stage 3
SELECT/ RESELECT ADVISERS FOR SALE
Merchant bank brokers, solicitors etc. chosen for sale
GOOD RESULTS
CHOOSE MARKET SLOT
Decision taken on how many shares to sell and how to fit sale in with other issues
PRODUCT PROSPECTUS
BUILD IMAGE
Advertising starts
FINAL DECISIONS
Final go-ahead given; price decided
SELL
100 per cent sold
Stage 4
TRANSFER OF OWNERSHIP FROM PUBLIC SECTOR TO PRIVATE SECTOR COMPLETED

Source: Charles Vuylsteke, Techniques of Privatisation of State-Owned Enterprises, vol. 1. Methods and Implementation (Washington, D.C., World Bank, 1988), p. 96.

Note: PLC = public limited corporation.

Formal plans to privatize BT were announced in a July 1982 White Paper by the Department of Trade, entitled "The future of telecommunications in Britain". Essentially, instead of fragmenting BT to promote competition, as it had done in the case of British Shipbuilders, the Government planned to sell slightly more than a majority of BT shares to the public. A new competitive framework was established by the Telecommunications Act of (April) 1984. Among its provisions, BT lost its exclusive privileges, and licensing was required for all telecommunication operators. While the Secretary of State was nominally responsible for granting such licenses, he could delegate this function to the director general of telecommunications, heading the newly created regulatory body, the Office of Telecommunications (OFTEL). The director general's main duties were to monitor market competition and enforce licence conditions. 1/

30. In addition to promoting competition through private ownership, another main objective in privatizing BT was to attempt to double the number of British shareholders by attracting some 2 million first-time investors, about 50 per cent of whom would retain their shares for the long run. This meant that a considerable amount of time, effort, and money would have to be spent on building up the company's image as an investment opportunity and disseminating the publicity widely. Almost one year in advance, at the end of 1983, British Telecom retained a leading public relations company to take charge of its corporate advertising and work together with a second firm responsible for the share offer publicity.

31. A certain amount of organizational restructuring took place in 1984, including the replacement of one half of the members of the Board. Financial restructuring also took place to improve the balance sheet debt to equity ratio, from 60 to 48 per cent, as shown in table 8 (Hyman, 1988, p. 130).

32. This was mainly effected by converting the government debt to unsecured loans and not transferring the long-term liabilities for pensions to the new entity. As a result, the company's equity increased by £1.3 billion.

33. Transfer of the public corporation business to the private company took place in August 1984, and shares went on sale to the public at the end of November. The Government's success in selling some 3 billion shares simultaneously in five countries merits a brief description.

34. Because the Government was attempting to raise a considerable sum of money - between £3 billion and £4 billion - in the largest single share offering attempted to that time, it considered institutional support to be a critical necessity. Consequently, it decided to engage in the underwriting process. Under such an arrangement, an issuing house, or group of houses, known as the lead underwriters, agrees to acquire a certain number of shares at a certain price and under certain conditions. To distribute the risk, brokers acting on behalf of the leaders approach potential long-term shareholders, such as managers of various institutional funds, known as sub-underwriters. If investors do not take up shares offered them by the lead underwriters, the shares are then offered to the sub-underwriters. Three sets

Table 8. British Telecom pro-forma balance sheet showing effect of restructuring (1984)

	Amount (millions of £)	
	Before privatization	After privatization
Government loans	(2 790)	--
Unsecured loans	--	(2 790)
Other net assets	8 740	8 696
Total	5 950	5 990
Ordinary shares	--	1 500
Preference shares	--	750
Long-term liabilities	1 250	--
Reserves	4 700	3 740
Total	5 950	5 990

of commissions are involved: 0.5 per cent to the lead underwriter, 0.25 per cent to the broker, and 1.25 per cent to the sub-underwriter. While this can be a costly procedure for the issuer, it has two perceived advantages: a reputable underwriter provides market confidence, and the proceeds are guaranteed (Grimstone, 1988, p. 110).

35. The main players in the sale of BT shares to the British institutions were a lead underwriter, a lead broker, and three other brokers. A number of institutions were identified as potential sub-underwriters and divided into two groups, one being larger in size than the other. The brokers commenced preliminary meetings with the institutions in January 1984, concentrating at first on the larger group. The contacts continued intermittently until August. In the summer, four brokerage firms issued research reports for institutional investors, with follow-up meetings and tours of BT establishments. Because of the size of the offering, participation by all the major institutions was considered essential, so personal selling campaigns were intensive.

36. In the late spring, a "priority application" plan was put forward whereby sub-underwriters were invited to apply for the entire domestic issue in return for a guaranteed percentage of the available shares, irrespective of the demand by non-institutional investors. The Government finally agreed on a 55-per-cent guarantee which, with hindsight, was very high because of the unexpectedly strong private demand.

37. The main publicity campaign directed towards the general public went into high gear in July 1984, in the press, on the radio and television, and in notices included in customers' bills. More than 2 million people applied for shares, which was 15 per cent over the target. Also over target was the size of the demand: the public was ready to buy four times the total number of shares offered - that is, nearly 13 billion shares were applied for.

38. Other management employee buy-outs proceeded differently. For example, the National Freight Company Ltd., although a large company, with some 30,000 employees, was sold to a management/employee consortium, because its financial condition was not considered sufficiently strong to support a public share offering. The Government wrote off some of the debt and sold the corporation for £53.5 million, of which only £2.5 million in cash had to be paid in. The balance came from a medium-term loan secured by the company's assets. To raise the cash, the consortium issued shares which were 80 per cent subscribed to by the current workforce and pensioners, for an average investment of about £700 per employee. Since that time, the value of the shares has risen about 10 times (Vuylsteke, 1988, p. 31).

39. Following the British Shipbuilders fragmentation, managers and employees invested an average of about £300 in buying out the Vosper Thorneycroft Shipyard and the Vickers and Cammell Laird war shipyards. Preferential treatment given to the employees included interest-free loans for amounts less than £500 and some additional special loans. Furthermore, shares could be purchased for £1 by the employees' consortium, representing an 80 per cent discount from the price charged to professional investors (Vuylsteke, 1988, p. 31).

40. Despite the Government's strong support for privatization, only about 25 per cent of the public sector had been brought under private ownership during the first seven years of the programme. Some interrelated factors were the cause of this delay. Although the Government's policy was to privatize as fast as possible, many of the industries were in poor economic and financial condition. A certain amount of restructuring was necessary to enhance their market appeal. The restructuring was usually both organizational and financial, and in some cases the process of building up the evidence that a candidate would have commercial viability took a good deal of time. The minimum feasible time for privatizing the British Airports Authority, for example, was about 16 months, but some four years elapsed before BAA PLC shares were ready for public sale (Heath, 1988, p. 175).

41. De-nationalizing British Airways also involved a very protracted length of time, and was quite costly. Over £400 million in rationalization costs provisions burdened its operating results for the year ended 31 March 1982, for example. To cut costs, it laid off a large number of employees, closed down unprofitable routes, and replaced some of its fleet with more modern equipment. To attract and retain new business, other outlays had to be made, for such things as advertising campaigns, and improving the quality of service. Top-level management and Board changes were also introduced, with a new Board chairman, chief executive, and chief financial officer in place before the privatization occurred (Hyman, 1988, p. 127).

42. Another major motive for restructuring before privatization has been to promote competition. The restructuring can take several forms, including down-sizing and splitting off. Down-sizing involves the selling off of peripheral assets while maintaining a basic core enterprise. This approach was used in the case of British Shipbuilders, which was fragmented into separate enterprises in order to create a competitive environment out of a monopoly situation. Splitting off, on the other hand, breaks up an enterprise into its main component parts. British Rail, for example, split off certain operations such as the British Rail hotels and Sealink, which were competing with the private sector, so as to expand the opportunities for private ownership.

IV. ACCOUNTING IMPLICATIONS OF PRIVATIZATION 2/

A. Accounting in the nationalized industries

43. The fact that the nationalized industries are organized as public corporations and use accounting and reporting systems which are similar to those of the private sector significantly reduces the number of accounting-related problems potentially involved in the privatization process. The rules governing accounting and reporting by the nationalized industries come from three main sources: legislation and ministerial direction; private sector practice; and self-regulation (Likierman, 1979, p. 5). The legislation covering a particular industry requires that the form of its accounts be approved, or directed, by its Minister, with additional approval by the Treasury. It is a matter of general policy, although not necessarily spelled out in each piece of legislation, that accounts are to be kept in accordance with "best commercial practices". These, in turn, are drawn from the companies acts, the requirements of the stock exchange, professional regulations, and any other appropriate and generally accepted accounting practices.

44. As a result, nationalized industries prepare the three traditional financial statements - balance sheet, profit-and-loss accounts, and a source and application-of-funds statement - plus possibly a statement of retained profits and reserves. Notes to the accounts, including statements of accounting policies and supplementary data, also form part of the accounts. For public corporations, the supplementary information is likely to be,

comparatively, quite voluminous, including various financial and nonfinancial statistical data required by the white papers or otherwise connected with the corporation's role as a mechanism for achieving certain social objectives.

45. Self-regulation of the nationalized companies is carried out through the Nationalized Industries Chairmen's Group. Its 1979 guidelines on inflation acccunting influenced the adoption of current cost accounting by most of the public corporations while the practice was still voluntary for the private sector.

46. The Post Office accounts provide an interesting example of the reporting accommodations required when accounts are prepared on two different bases: historical cost, and current cost. In 1985, Girobank PLC was created out of the property, rights, and liabilities of the Post Office Corporation's Girobank business and incorporated in England as a wholly owned subsidiary of the Post Office. 3/ The following year, Post Office activities were restructured organizationally into three separate businesses: Royal Mail letters, Royal Mail parcels, and Post Office counters, plus central services. For the year ended 1 April 1987, the consolidated accounts for the Group - that is, the Post Office and Girobank and for the separate sets of accounts for the Post Office's three main businesses were presented on the current-cost basis. The Secretary of State's direction to the Post Office with respect to the Girobank business required that its accounts adhere to established formats. Accordingly, the separate accounts for Girobank PLC were presented on the historical-cost basis, together with supplementary current-cost information in the form of a balance sheet, profit-and-loss account, and accounting policies and notes.

47. Supplementary current-cost information is rarely included in the accounts of private companies because of lack of direction as to format by the Accounting Standards Committee (the former standard-setting body, which has been replaced by the Accounting Standards Board). After the privatization of British Telecom, accounts were presented on the historical-cost basis with separate current-cost disclosure for the two prior years. The current-cost disclosure has now, however, been discontinued for the private sector, although it is still required in the public sector (Hyman, 1988, p. 133).

48. Other accounting-related problems which may be encountered in the transition from public to private corporation status include those involving the lack of availability or poor quality of prior transaction data, differences in capitalization and depreciation policies, and the existence or status of liabilities (Hyman, 1988, pp. 132-137).

49. Some public corporations, such as British Telecom and the British Airports Authority, were organized out of former government departments which kept their accounts on the cash basis. Apart from the difficulty of segregating accounting data for activities which are split off, one of the main difficulties with a cash-based accounting system is that, unlike the accrual-based system which the private sector is required to use, it does not provide for matching expenses against revenues in the same accounting period

so as to determine properly operating results. In the case of British Telecom, the auditors had to issue a disclaimer of opinion on the financial results for the years ended on 31 March 1980 and 1981 because of significant uncertainties connected with application of the matching principle. For example, conventional accounting procedures with respect to fixed assets had not been followed. This is because, under a cash-based system, capital asset acquisitions are accounted for as expenditures against budget appropriations rather than as depreciable assets. Also, allocations of revenues between those two fiscal years had to be estimated, because industrial action had interfered with the usual billing procedures. Difficulties in determining both revenues and operating costs, therefore, precluded the auditors from being able to attest to the fairness of presentation of the financial results and to the source and application of funds for those years. It also follows that the poor quality of financial information available for periods prior to privatization makes it difficult for management to present the customary five-year comparative data.

50. Even when public corporations account for fixed assets as capital acquisitions, certain classification changes and revisions of estimated asset lives for depreciation purposes may be called for. In the British Telecom prospectus, for example, the auditors wrote off a significant amount (£196 million) of capitalized costs for telephones and connection installations which should have been expended as nonrecoverable outlays. Estimates of depreciable asset lives may need extending or shortening when a corporation prepares for entry into a new operating environment. Profits for British Gas rose by just under £500 million over a three-year period due to audit adjustments to increase asset lives. Audit adjustments to decrease service lives on British Telecom assets, on the other hand, adversely affected profits by about £130 million for the five-year period covered in its prospectus. However, the auditors also added back amounts ranging between £361 million and £626 million for the period 1980 through 1983 for supplementary depreciation charged by British Telecom for certain fixed-asset replacement costs, since this practice is not in accordance with generally accepted accounting principles in the private sector (Hyman, 1988, p. 134).

51. Of the various liabilities which a public corporation may have partially or completely failed to record in its accounts, one of the most potentially significant may be pension obligations. In the case of the management buy-out of the National Freight Company in 1982, the Government paid £47 million into the pension fund before the sale. British Telecom's liability for a £1,250 million pension underfunding, on the other hand, was removed from the privatized company's balance sheet as a restructuring decision (Hyman, 1988, pp. 135-136). In addition to defining the liabilities and funding, decisions also have to be reached about the future financial arrangements for pension coverage. Three different approaches have been tried in the United Kingdom (Hyman, 1988, p. 136): allowing employees to remain covered by the public-sector plan even though they would be employed in a private company, as in the case of the British Shipbuilder's warship yards; dividing the pension fund between various privatizing entities, as applied to the subsidiaries of the National Bus Company; or, starting a new pension plan for new employees of

the privatized company, while leaving the existing plan available only to those covered by it previously, as in the case of British Airways.

B. Accounting and valuation processes

52. Two main types of problems typically affect the usefulness of accounting information for valuation processes: relevance, and reliability. As discussed above, data gathered in the past for one set of purposes may have little relevance for a reorganized entity which will be operating in a different environment. The reliability of such past data may also be highly suspect for changes in the type of system of accounting, changes in the basic assumptions that underlie accounting estimates and calculations, and the lack of verifiability that it is reasonably free of error and bias.

53. In BT's case

> ... the problems of valuation were particularly acute. The company had no history as a commercial organization; there were no comparable companies in the United Kingdom, and only distant relations in the United States; and the company did not even have very reliable financial accounts. This made the job of those responsible for the flotation and for advising on the issue price very difficult. (Hawkings, 1987, p. 2)

54. The key to unlocking the valuation problem turned out to lie in the expectations of the sub-underwriters. To be an attractive investment to the institutional investors, BT stock had to provide a certain yield; and because the Government placed such importance on their purchasing power, the institutions had a strong hand in the bargaining for an acceptable yield. This led to setting the initial share selling price. It should, perhaps, be clarified that the share price is a residual when the amount of the dividend is set and the dividend yield is agreed upon.

55. Accounting information can be very useful in helping to assess cash flows, internal funding requirements, and the required dividend coverage, all of which are elements entering into the dividend calculation. Based on its unpublished, estimated cash flow projections as of March 1984, the dividend was set at 6.5 pence per share net for the 1985 financial year. By the end of October, just one month before the share issue, the figure had been revised upwards to 7.14 pence and a round number of 1.30 per share arrived at by using a yield rate that it was assumed the institutions would accept. 4/

56. After the initial offering, the considerable excess demand combined with the instalment payment provisions meant that BT shares were soon selling at a premium. This is a very frequent phenomenon with fixed-price offers, as shown in table 9, and the reasons for the premiums on the other issues are similar to those that applied to the BT experience: large numbers of shares coming on to the market, guaranteed percentages of the offering to institutional investors, and the discounting of current market prices when pricing secondary offers (Hyman, 1989, pp. 208-209).

Table 9. Premiums on new issues of shares: fixed price offers

	Offer/ striking price	Price at one week a/	Premium (percentage)
Amersham International	142	192	35
Associated British Ports	112	141	26
BAA (fixed price portion of offer)	245	280	14
British Aerospace	150	178	19
British Airways	125	169	36
British Gas	135	149	11
British Telecom	130	172	33
Britoil (tender)	215	189	(12)
Cable & Wireless	168	198	18
Enterprise Oil (tender)	185	186	--
Jaguar	165	177	7
Rolls Royce	170	288	34

Source: Howard Hyman, "Privatization: the facts", in Privatisation and Competition, C. Veljanovski, ed. (London, Institute of Economic Affairs, 1989), p. 207.

a/ Grossed up for all future instalment payments.

57. Much of the experience in the United Kingdom has shown that accounting data have to be used with caution in the valuation process and may require considerable analysis and restatement. In very difficult valuation cases, competitive bidding and the services of professional valuers have proved effective surrogates.

58. A very valuable feature of public enterprise accounting in the United Kingdom has been, as shown, the use of the corporate form of organization and accounting practices that are compatible with those in the commercial world, to a large extent. To this must be added the background and qualifications of

those responsible for finance and accounting in the nationalized industries. Most, if not all, of the chief financial executives were recruited from the private sector and were thoroughly acquainted with many of the accounting and finance-related aspects of the transition to the commercial environment.

Notes

1/ For a critical assessment of this privatization strategy, refer to Vickers and Yarrow (1986).

2/ This section relies on Hawkings (1987) and Vickers and Yarrow (1986), except as noted.

3/ As of 1 April 1987, Girobank PLC had 18 wholly owned subsidiaries providing leasing, finance, and the undertaking of investments.

4/ For a full account of the BT share price-setting details, refer to Hawkings (1987).

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